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UNITED STATES INTERNATIONAL DEVELOPMENT COOPERATION AGENCY
AGENCY FOR INTERNATIONAL DEVELOPMENT
Washington, D. C. 20523

GUATEMALA

PROJECT PAPER

PAAD

Grant Number:520-K-601
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AID 1120-1 (8-68) PAAD	DEPARTMENT OF STATE AGENCY FOR INTERNATIONAL DEVELOPMENT PROGRAM ASSISTANCE APPROVAL DOCUMENT	1. PAAD NO. 520-0347 520-K-601 (G) - 520-K-041(L) 2. COUNTRY Guatemala 3. CATEGORY Cash Transfer 4. DATE

5. TO: AA/LAC, Dwight Ink	6. OYB CHANGE NO.
7. FROM: LAC/DR: Terrence Brown TB	8. OYB INCREASE TO BE TAKEN FROM: Economic Support Fund (ESF)
9. APPROVAL REQUESTED FOR COMMITMENT OF: $ 47,350,000	10. APPROPRIATION - ALLOTMENT LESA-86-35520-KG31 (637-65-520-00-50-61) LESA-86-35520-KL31 (637-65-520-00-58-61)

11. TYPE FUNDING	12. LOCAL CURRENCY ARRANGEMENT	13. ESTIMATED DELIVERY PERIOD	14. TRANSACTION ELIGIBILITY DATE
[X] LOAN [X] GRANT	[ ] INFORMAL [X] FORMAL [ ] NONE	FY 1986	Date of Authorization

15. COMMODITIES FINANCED

16. PERMITTED SOURCE	17. ESTIMATED SOURCE
U.S. only:	U.S.: $23,925,000 (L); $23,425,000 (G)
Limited F.W.:	Industrialized Countries:
Free World:	Local:
Cash: $47,350,000	Other:

18. SUMMARY DESCRIPTION

The purposes of this cash transfer ($23,925,000 loan; $23,425,000 grant) are 1) to provide immediate balance of payments support to Guatemala; 2) to support economic reform; and 3) to sustain and deepen the democratization and development processes. The first of two disbursements will be made upon submission by the Government of Guatemala (GOG) of an acceptable economic stabilization program for 1986 and the implementation of some initial steps under that program. The second disbursement will be made upon the GOG's making further progress in meeting stabilization program goals. The two disbursements may be combined into one if all conditions precedent have been met as of the scheduled date of the first disbursement.* Within 12 months following the disbursement of funds, the GOG will make available an equivalent amount of dollars for the import of raw materials, spare parts, and intermediate goods from the U.S. for use by the productive sectors in Guatemala. Immediately following each of the disbursements of program funds, the GOG will deposit an equivalent amount of local currency calculated at the highest rate of exchange which, at the time the deposit is made, is not unlawful in Guatemala, in a special account in the Central Bank of Guatemala. The local currency will be used for mutually agreed development purposes, including an operating expenses trust account and counterpart funding for development programs consistent with the Foreign Assistance Act, particularly Sections 103 through 106, and Section 123. *The substance of the CPs may be included in a side letter to the Loan/Grant Agreement.

19. CLEARANCES	DATE
LAC/DP, P. Sellar (draft)	
LAC/GC, P. Johnson (draft)	23 May 86
AA/PPC, A. Herrick	26 Apr 86
M/FM, C. Christensen	5/6/86
ARA/ECP, R. Beckham	4/25/86
LAC/DR, L. Klassen	4/24/86
LAC/DAA, M. Butler	
LAC/CEN, P. Askin	4/25/86
LAC/CONT, D. Robbins	5/6/86

20. ACTION

[X] APPROVED [ ] DISAPPROVED

Dwight Ink 5-22-86

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TITLE

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GUATEMALA

PROGRAM ASSISTANCE AUTHORIZATION DOCUMENT

(PAAD)

FY 1986

January 1986

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1. EXECUTIVE SUMMARY

A Changing Guatemala

As we enter 1986, the Guatemalan nation is ending an era of 30 years of nearly uninterrupted military rule characterized by high levels of civil violence and insensitivity to human rights. In the last years of this period, Guatemala suffered through a widespread armed insurgency and, in addition, finds itself in serious economic decline. Beginning with the Constituent Assembly election of July 1984 and culminating in the inauguration of Christian Democrat Vinicio Cerezo as President on January 14, 1986, Guatemalans of all levels of society joined in a mounting crescendo of public opinion endorsing a return to democratic government.

Current levels of political violence are lower than they have been in years and there is widespread hope this time that the decline can be more than a passing phenomenon. With their votes, Guatemalans have acted to move their country to a new era of freely elected civilian government in a bid to end domestic violence and to bolster a sagging economy. The landslide victory of Vinicio Cerezo and the attainment of an absolute majority for his party in the new Congress provide a clear mandate for change and the opportunity to enact a bold agenda of economic, political and social reform.

Yet, the range of changes needed and the austerity that will accompany them make the challenge to effective government a formidable one. The purpose of this FY 1986 Program Assistance Approval Document (PAAD) is to initiate a U.S. multi-year balance of payments (BOP) assistance program with FY 1986 inputs of up to $75 million to support economic reform and to sustain and deepen the democratization and development processes. Agreement on adequate reform measures should attract other international donor and private borrowing and investment packages sufficient to stabilize the economy and renew the traditional Guatemalan pattern of private sector-led economic growth.

As recently as ten years ago Guatemala's economy was still vibrant and stable, foreign exchange holdings high, the quetzal competitive at one to one with the U.S. dollar. Although social inequities were widespread and domestic violence had been endemic for almost as long as anyone could remember, few could have accurately forecasted the scale and rapidity of the economic deterioration, the recession that has occurred and the critical state in which the nation finds itself today.

The current economic situation results from the failure by successive governments to adjust policies to offset a series of setbacks (world oil price hikes, Central American Common Market stagnation, low world prices for traditional imports, sharp declines in tourism) plus the paralyzing effects of a major insurgency.

As difficult as Guatemala's specific problems have been, in many ways they mirror those of the region. Similar economic, social and political instability in recent years has adversely affected all countries in the region and disrupted orderly government, development planning and the flow of business activity. Following on the NBCCA recommendations, massive American assistance to Costa Rica, Honduras and El Salvador has been made available under the CENTRAL AMERICAN INITIATIVE to counter these trends.

Despite the fact that Guatemala was experiencing the same problems, until quite recently only minimal U.S. assistance was provided. The prevailing view in the U.S. Government and the public at large was that Guatemala's insurgency of the late 1970s and early 1980s was spurred in large part by the failure of successive governments to redress legitimate and long-standing grievances endured by many of its citizens, particularly the highlands indigenous population.

Today, considerable political progress has been made and the nation is moving decisively in a positive direction. Guatemala has successfully weathered the terrible insurgency, but with great loss of life and economic vitality. It remains true that extremists of both right and left persuasions continue to play a visible role in the public life of the nation.

Still, this should not obscure the fact that the dominant political reality in Guatemala today is an expansive, emphatic and successful movement toward a more open and democratic form of government. The conviction of the vast majority of Guatemalans and their new leaders is that this return to a freely elected form of government and a deeper commitment to participation by all elements of society in the benefits of economic growth is necessary and desirable and is a pre-requisite to ending both the armed insurgency and right-wing violence.

Yet, even as this promising political scene is unfolding, economic storm clouds are gathering that have the potential to undo all that has been gained. As will be described shortly, the case for a larger and more flexible U.S. program of assistance is strong. The timeliness and types of assistance are of utmost importance to the support of the democratization process underway, to the economic recovery, and to the strategy of growth with equity. Without early and effective economic gains in the life of the new Government, it is doubtful its progressive political and social agenda can survive. The following two sections of this Executive Summary, outline respectively the current economic situation and the Mission's prescriptive look at how U.S. ESF assistance should be structured.

2. Current Economic Situation

Recent Mission reports describe the current Guatemalan recession as an "unprecedented economic crisis." The real growth rate for 1985 is estimated to have been about -1.5%. This number alone does not capture the depth of the economic difficulties Guatemala is now experiencing.

In earlier years, Guatemala's once comfortable level of international reserves served as a cushion to buffer the effects of external shocks and internal policy deficiencies. In 1985, with reserves completely exhausted and the spigot of international financing closed, Guatemala suffered for the first time serious delinquency on its international payments, supply dislocations for petroleum and other essential inputs, and the substantial depreciation of its parallel currency rate. The productive sector is largely stagnant at present. Tables and charts throughout the main body of this PAAD show and review Guatemala's recent economic data and the factors which have culminated in the present crisis.

Two other key economic factors are worth noting in this Executive Summary.

One, balance of payments difficulties forced recourse to increased short-term external borrowing in recent years, which in turn has caused debt service payments to skyrocket. In 1980, debt service required only 4% of export earnings; in 1985 this ratio jumped to 38% and is projected to reach nearly 50% in 1986.

Two, the growth in expenditures at pace with inflation means that the fiscal deficit, low in 1985, will widen substantially in 1986. Tax revenues as a percentage of GDP have eroded over time, from more than 10% in the late 1970's to less than 5% projected for 1986. This collapse of the Guatemalan revenue system has been dealt with through severe cutbacks in the country's development budget, with the result that Guatemala's achievements in education, health and rural infrastructure, traditionally low, remain among the lowest in the region. Despite a per capital income level similar to Costa Rica, educational and health attainments in Guatemala more resemble Honduras and, in some cases, Haiti. It is clear that the groups paying the highest price in the recession are the urban and rural poor, whose real incomes have been steadily deteriorating as a result of the inflation fueled by the economic dislocations described above.

Policies continued or adjustments taken in the last two years have exacerbated the downturn.

-- To help achieve external balance, the Guatemalan government established a multiple exchange rate system in late 1984. However, the arbitrary and complex set of rules governing the system has led to foreign exchange shortages, decreased incentives to export and a continuing black market.

-- The unsustainable subsidies for gasoline and other petroleum products inherent in the foreign exchange regime were primarily behind fuel shortages for 1985. If the subsidies continue, recurrences in 1986 are as likely as not. The short-term external credits provided to import oil in the last quarter of 1985 will fall due on the new government in its early months.

-- A wide-ranging set of price controls covering approximately 40 categories of consumer products was implemented in September 1985. Many of these products have since been in short supply. In the case of others, the controls have led to cost-additive product or packaging/labeling alterations to permit higher pricing.

-- An additional price distortion results from the highly negative real interest rates on savings and borrowing. Interest rate controls have worsened the foreign exchange shortages by encouraging savers to keep assets in dollars banked abroad or even in their mattresses, rather than in quetzal savings accounts in Guatemalan banks.

Examination of the past few years highlights a key point: the rundown of international reserves and recourse to borrowing in international markets allowed Guatemala to maintain a set of economic policies which produced a growing current account deficit, the progressive deterioration of its tax system and the near elimination of domestic sources of savings. To return to positive growth and to restore international reserves to healthy levels, an appropriate economic stabilization program should be agreed upon. A coherent economic program will halt the trend of continued impoverishment of Guatemala's disadvantaged groups and will regain investor confidence.

It is highly probable that if Guatemala does not take the necessary economic adjustment measures, the IMF and other international organizations will not be willing to provide the country with the much-needed balance of payments assistance. It will also become more difficult to reschedule the onerous 1986 debt service burden (some $630 million) and to obtain credits from the commercial banks. A satisfactory stabilization program would restore confidence in the currency, curtail the level of inflation, and open new sources of employment. The success of Guatemala's incipient democracy will depend to a large extent on the country's economic recovery and the triggering of sustained rates of economic growth.

3. USAID's ESF Program: A Prescriptive Look

It is essential that USAID's ESF resources are lined up squarely behind a credible and comprehensive stabilization program on the part of the new Government of Guatemala. It is also essential that the substance of such a program be agreed on early in the negotiations. Toward this, the Mission has prepared an initial list of the symptoms of the current economic problems, an analysis of the root causes of each and a set of corrective policy prescriptions.

An ESF program that targets individual policy reforms would probably be insufficient (see Table), given the interrelatedness of the problems in each area of the economy. A comprehensive package in the fiscal, monetary and external sectors would contribute much more to the country's economic recovery and would tend to attract the needed support from other international donors and the commercial banks.

Given the Mission's projection of a $392.3 million financing gap for 1986 (for a target real growth rate of 1.5% for 1986), U.S. assistance alone, through ESF and other programs, falls far short of the total needed. Furthermore, in addition to meeting Guatemala's balance of payments gap, external inflows will be required to rebuild the country's international reserve position.

Thus, a comprehensive policy package should include measures tending toward unification of the multiple exchange rate, reduction in the fiscal deficit without the sacrifice of programs in support of development, increased reliance on domestic savings through liberalization of interest rate policy, and dismantling of the pricing distortions implied in both the exchange system and commodity price controls.

The Mission proposes that initiation of the ESF program in 1986 be linked to a written request from the Guatemalan Government for balance of payments assistance which outlines a stabilization program. Disbursement of the first $25 million will be triggered by the implementation of the initial steps of the program. Other resources will be made available to support additional steps and progression from fundamental measures to stabilize the economy during the immediate crisis to greater emphasis on a long-term policy climate to foster productivity and growth.

Any stabilization package implies a cost in terms of economic adjustment. Certainly, Guatemala's poorest groups have been severely hurt in the recession, through burgeoning inflation and higher unemployment. It is important, therefore, that all sectors of Guatemalan society share the burden of the economic stabilization program, not only the country's less privileged groups. The positive effects of the national development program (including donor activities) are endangered both by these factors and a reduced government ability to provide counterpart funds. In response, ESF local currency resources will be targetted toward reenergizing private sector growth opportunities and toward projects that sustain the development program objective of increased incomes and opportunities for the rural and urban poor.

4. Recommendation

USAID/Guatemala recommends FY 1986 authorization of Economic Support Fund loans and grants of up to $75 million to Guatemala, beginning in early 1986 with a cash loan of $23,925,000 and a grant of $1 million to offset the Operating Expenses trust fund.

5. Borrower/Grantee

The Borrower/Grantee will be the Government of Guatemala, represented by the Bank of Guatemala and the Ministry of Finance.

Elements of An Economic Stabilization Program for Guatemala

A. Symptoms of Economic Policy Problems

Symptom:	Root Cause:	Policy Prescription:
I. Inflation	Corrective Inflation - caused by depreciation of quetzal in parallel market.	Restrain pressure on quetzal through fiscal and monetary policies which reduce demand for imports, encourage capital inflows.
	Noncorrective Inflation - caused by excessive monetary expansion due to fiscal deficit and exchange losses of the Central Bank.	Increase revenues through better tax administration and steps to increase tax system elasticity.
		Maintain noninflationary level of credit expansion by Central Bank.
		Eliminate exchange losses through exchange rate unification.
II. Disorder in Foreign Exchange Market	Overly complex and arbitrary foreign exchange system leading to resource misallocation.	Simplify through unification.
		Eliminate exchange system "taxes and subsidies" or replace these with fiscal measures.
III. Scarcity of Foreign Exchange for Producers	High debt service requirements in 1985 and 1986.	Renegotiation of external debt through Paris Club rescheduling (normally requires IMF agreement).
	Structural deficit in official (Q1 per $1) market.	Eliminate deficit by placing more import transactions in parallel market, and ultimately through unification.
	Lack of access to international sources of finance for balance of payments deficits.	Implementation of a credible economic program which improves ability to meet current debt payments.
IV. Insufficient Investment and Capital Flight	Political instability, both internal and external (Nicaragua's Sandinista regime and its policy of exporting revolution); inconsistent and frequently revised economic policy.	Restore confidence through credible, comprehensive stabilization program which should include greater reliance on a responsible private sector and particularly on the development of non-traditional export-oriented industries.
	Interest rate policy discourages savings, encourages speculation.	Greater flexibility and market orientation for interest rates to savers and borrowers.
V. Lack of Opportunity for Rural and Urban Poor (especially in health care, education and employment)	Insufficient public sector investment in human capital and physical infrastructure, especially to increase economic endowments of the urban and rural poor.	Increased public sector investment in favor of equity and development.
		Increased employment through increased private sector investment and growth.

B. Summary: Comprehensive Guatemala Stabilization Program

A credible economic stabilization program incorporating:

(1) Reduction in the fiscal deficit through expenditure restraint and higher revenues,

(2) More market-oriented pricing policies for goods and capital (interest rates),

(3) Unification of the exchange rate,

(4) Rapprochement with the IMF and external debt renegotiation.

(5) Greater reliance on private sector investment and the promotion of export-oriented industries.

Plus greater emphasis on equity and participation for the urban and rural poor through:

(1) Reduction in inflation to pre-1985 levels,

(2) Increased public investment in education, health care and rural development, and

(3) Increased employment through higher private sector investment levels and policies which improve productivity and expand export incentives.

REQUIRED SUPPORT TO THIS EFFORT:

U.S. Government:

(1) Balance of payments support in 1986 and 1987,

(2) Local currencies and some DA used to support public sector investment,

(3) CCC, TCIP credits and PL 480, Title I assistance,

(4) Technical assistance in design and study of economic policy.

Other donor support will also be essential:

(1) An IMF program, to provide additional resources and pave the way to debt rescheduling,

(2) A World Bank Export Promotion Project followed by a Structural Adjustment Program, to also help meet balance of payments gap,

(3) Continuing economic reactivation project assistance through the IDB.

(4) Rescheduling of 1986 debt service payments.

2. COUNTRY BACKGROUND

In the last year, in a bid to end domestic violence and to bolster a sagging economy, Guatemalans have moved dramatically toward a democracy through free national elections for a civilian government. The purpose of this FY 1986 Program Assistance Approval Document (PAAD) is to initiate a balance of payments (BOP) assistance program in support of the democratic process and economic reform aimed at stabilization and higher growth rates.

As recently as ten years ago Guatemala's economy was still vibrant and stable, foreign exchange holdings high, the quetzal competitive at one to one with the U.S. dollar. Although social inequities were widespread and domestic violence had been endemic for almost as long as anyone could remember, few could have forecast the scale and rapidity of recent economic deterioration.

However, on the eve of Guatemala's return to democratic rule, an unprecedented economic crisis threatens the social and political order. The external roots of the downturn are common to all countries of Central America: political instability, capital flight and worsening terms of trade. Flawed domestic policies in the early eighties of increased external borrowing, expanded fiscal deficits and the drawdown of Guatemala's once substantial international reserves served to eventually compound the problem, with today's results of negative real growth and a depreciated quetzal. Renewed economic prosperity in the future will come only with the adoption of a stabilization package which addresses the structural distortions which have built up in the Guatemalan economy in the past decade.

Despite the fact that Guatemala was experiencing the same problems as other countries in Central America receiving massive American assistance, until quite recently only minimal U.S. assistance was provided. The prevailing view in the U.S. Congress and the public at large was that Guatemala's insurgency of the late 1970s and early 1980s was spurred in large part by the failure of successive governments to redress legitimate and long-standing grievances endured by many of its citizens, particularly the Highlands indigenous population.

Despite continuing problems, considerable progress has been made and the nation is today moving in the right direction. Guatemala has succcessfully weathered the terrible insurgency of the early 1980s, but with great loss of life and economic vitality. It remains true that extremists of both right and left persuasions continue to play a visible role in the public life of the nation. Still, this should not obscure the fact that there is a large, emphatic and increasingly successful movement toward a more open and democratic society. The conviction of the vast majority of Guatemalans is that the return to a freely elected form of government and a deeper commitment to participation by all elements of society in the benefits of economic growth are necessary and desirable and are prerequisites to ending both the armed insurgency and government-sanctioned violence.

Following on the successes of the July 1984 Constituent Assembly elections and the drafting of the new Constitution, the country moved decisively to free and fair elections in November and December 1985. The orderly transfer of power to a democratic civilian government took place January 14, 1986. This progress has been made despite the continuing effects of the insurgency, human rights problems and a deepening economic crisis. The case for a larger and more flexible U.S. program of assistance is strong. The timeliness and types of assistance are of utmost importance to the support of the democratization process underway, to the economic recovery, and to the strategy of growth with equity. Without effective economic gains early in the term of the new Government, it is doubtful the progressive political and social agenda of President Cerezo's Administration can survive.

3. Economic Overview

A. Recent Economic Trends

Introduction

The Mission has described the current Guatemalan recession as an "unprecedented economic crisis." The real growth rate for 1985 is projected to be negative one and one-half percent. This number alone, however, does not capture the depth of the economic difficulties Guatemala is now experiencing. In earlier years, Guatemala's once comfortable level of international reserves served as a cushion to buffer the effects of external shocks and internal policy deficiencies. In 1985, with reserves completely exhausted and the spigot of international financing closed, Guatemala suffered for the first time serious delinquency on its international payments, supply dislocations for petroleum and other essential inputs and the substantial depreciation of its parallel currency rate.

The economic palliatives chosen in 1985 to deal with these problems are proving counterproductive, particularly arbitrary and unpredictable manipulations of the multiple exchange rate regime, institution of a wide-ranging set of price controls, and unsustainable subsidies to certain products through the exchange system. The groups paying the highest price in the recession are the urban and rural poor, whose real income has steadily deteriorated as a result of the inflation fueled by the economic dislocations described above.

This section reviews Guatemala's recent economic performance, and the factors which have culminated in the present economic crisis. Examination of past years highlights a key point: the rundown of international reserves and recourse to borrowing in international markets allowed Guatemala to maintain a set of economic policies which produced a growing current account deficit, the progressive deterioration of its tax system and the near elimination of domestic sources of savings. To return to positive growth and to restore international reserves to healthy levels will require, first and foremost, a commitment to an economic stabilization program. Such a program is urgently needed to halt the continued impoverishment of Guatemala's disadvantaged groups and to regain investor confidence.

If Guatemala does not take the necessary adjustment measures in the near term, it is unlikely that the IMF and other international organizations will be willing to provide the country with the much-needed balance of payments assistance. It will also become more difficult for the Guatemalan authorities to reschedule the onerous 1986 public external debt service burden (some $630 million) and to obtain new credits from the commercial banks. A satisfactory stabilization program will restore confidence in the currency, curtail the level of inflation, and open new sources of employment. The success of Guatemala's incipient democracy will depend to a large extent on the country's economic recovery and the triggering of sustained rates of economic growth.

Recent Economic Performance

Prior to 1980, Guatemala enjoyed decades of continual real growth. During the 1960's and 1970's, the country increased agricultural production, particularly for export, and built up a light manufacturing industrial base which generated products mostly for export to the Central American Common Market (CACM). This era of prosperity came to an abrupt end in 1980-81 as Guatemala felt the impact of external factors such as the recession in the industrialized countries, decreasing world prices for its major commodity exports, and regional and internal political turmoil. The external effects were exacerbated by the government's lack of timely response in adjusting domestic financial policies. This resulted in a recession which has continued to the present. The economy experienced negligible growth of .2% in 1984, and the Mission estimates that growth will again be negative in 1985 at about 1.5%. Even in the most optimistic of cases, it will take Guatemala the rest of the decade to regain the position attained by the end of the 1970's.

Annex 1 describes the current state of the Guatemalan economy in detail. Several recent economic trends will be briefly summarized here. Contraction is evident in almost all sectors of the economy, (as shown in Table 1), although those hardest hit are manufacturing, construction and commerce. Real gross domestic investment as a percent of GDP has fallen steadily, down from 12% in 1982, to 8% in 1984. This trend is due to reductions in both public and private sector investment.

Precise figures about total labor force and unemployment are not available for Guatemala. However, it is estimated that there were some 2.5 million workers in the work force during 1984, with about 74,000 new workers joining the labor force over the year. The unemployment rate increased from 8% in 1983 to 11-12% in 1984. It is expected that the 1985 figure will be even higher. Underemployment, at about

29-Dec-85

TABLE _1_: Guatemala GDP by Sector of Origin and Expenditures

1982 - 1986
(In 1958 Q's Millions)

	1982	1983	1984	GOG 1985e	GOG 1986e
PRIMARY PRODUCTION	775.2	747.9	767.6	758.1	
Agriculture	765.4	737.1	759.8	751.4	N/A
Mining	9.8	10.8	7.8	6.7	
SECONDARY PRODUCTION	629.9	594.4	575.8	562.4	
Manufacturing	475.1	466.1	468.4	464.6	N/A
Construction	102.9	76.8	53.4	43.0	
Public Utilities	51.9	51.5	54.0	54.8	
SERVICES	1612.2	1594.0	1614.8	1600.3	
Transport	199.3	200.7	204.8	205.8	N/A
Commerce	793.0	762.8	770.5	749.7	
Finance	109.7	107.1	109.5	109.8	
Housing	145.4	149.2	151.9	154.9	
Public Admin./Def.	176.7	187.6	190.3	192.2	
Other	188.1	186.6	187.8	187.9	
GROSS DOMESTIC PRODUCT	3017.3	2936.3	2958.2	2920.8	2877.0
(Memo: Annual Real Growth Rate)	-3.5	-2.7	0.7	-1.3	-1.5
Plus: Imports of Goods and NSF	334.3	269.2	284.8	254.3	226.4
Less: Exports of Goods and NSF	510.2	454.7	449.7	454.5	453.6
DOMESTIC EXPENDITURE	2841.4	2750.8	2793.3	2720.6	2649.8
CONSUMPTION	2509.7	2480.5	2505.6	2475.3	2442.1
Private	2280.2	2247.7	2272.5	2250.8	2220.7
Public	229.5	232.8	233.1	224.5	221.4
INVESTMENT	355.8	259.4	229.9	221.4	227.7
Private	196.9	151.5	161.8	159.6	159.6
Public	158.9	107.9	68.1	61.8	68.1
STOCK ADJUSTMENT	-24.1	10.9	58.5	23.9	-20.0

Source: Banco de Guatemala

p = Preliminary
e = Estimated

Note: This table is based on the GOG's estimate
of -1.5 percent real growth in 1986.

33%, continues to be a serious problem, especially in the rural areas. Wage increases in recent years have, at best, not kept up with inflation. In response to demands arising from escalating inflation, the Government in September, 1985, increased the monthly salaries of all except the highest paid public sector employees by 50 quetzals and imposed price ceilings on many basic food items. Some of the private sector firms followed suit by increasing salaries by varying amounts.

Historically moderate, the rate of inflation has begun to accelerate, registering 28% over the first nine months of 1985. The unprecedented increase in the price level reflects several factors. First, the depreciation of the quetzal parallel rate from Q1.45 to Q3.00 (with a peak of Q3.80 in August) raised the domestic prices both of goods with an imported component and of goods for whom export markets compete with local consumption. Not all 1985 inflation, however, can be attributed to a correction of relative prices resulting from the new exchange rate. The fiscal deficit of Q.220 million, primarily financed through expansion of domestic credit, was a contributing factor. More importantly, Central Bank losses increased the pace of money supply growth. The deficit in the official exchange market forced the Central Bank to purchase dollars in the banking market at the parallel rate, which were then sold to importers of essentials list commodities at Q1.00 per quetzal. The difference between dollars purchased at the parallel rate and then sold for Q1.00 was met through Central Bank creation of new money.

To deal with inflationary pressures, the Guatemalan authorities have increasingly resorted to price control measures. Interest rates have been maintained at levels of 12 percent for borrowers and 9 percent for savers. Both have turned highly negative in the past year. The result of this pricing distortion is that savers are now moving to convert their assets into physical property or into dollars, rather than placing them in quetzal savings accounts in Guatemalan banks. Borrowers lucky enough to have access to scarce credit prefer to invest in dollar instruments rather than in productive capital, since the negative real interest rate when combined with a depreciating quetzal translates into attractive profits.

Pricing controls have also been implemented in goods markets. In September, the prices of some 40 products were rolled back to their June-July levels and frozen. Many of these goods have since disappeared from the shelves or are in short supply. Intraurban bus fares have been maintained at a level which requires a fiscal subsidy to keep private sector operators solvent. A Q2 million per month subsidy was established in September with this goal in mind.

Throughout the 1980s, central government revenues have declined, from 9.5% of GDP in 1980 to 6.7% in 1985, mainly as a result of reductions in revenues from indirect taxes, both from domestic transactions and international trade. Central government expenditures have also declined as a percent of GDP, from 16% in 1981 to 10-1/2% in 1984 and 8.5% in 1985. While operating expenditures (whose major component is the public sector wage bill) have remained roughly constant, investment spending has plummeted. On the positive side, this trend reflects the completion of several major investment projects and the cancellation of other proposed projects of marginal payoff. On the negative side, recent budget cutting has extended into reductions in road and power plant maintenance, and postponement of school and health facility construction.

In the early 1980s, the Guatemalan government relied on foreign borrowing and the use of net official reserves to meet its chronic balance of payments deficits while maintaining the value of the quetzal at parity with the dollar. Medium and long-term public debt increased from U.S. $700 million in 1980 to U.S. $1.6 billion in 1984. Much of this new indebtedness was contracted from commercial lenders at higher interest rates. Also, the inability of the economy to generate enough dollars (at the overvalued exchange rate) to meet import demand led to a build-up of external payment arrears, which totalled nearly $500 million dollars by the end of 1984. More recently, there has been a further increase in short-term debt, contracted in 1985 to meet oil bills. Although Guatemala's total public external debt ($2.4 billion) is small by regional standards, the structure of repayment is highly unfavorable. $631 million in interest and principal is due in 1986 alone, about 44% of projected export earnings.

To finally deal with the unbearable pressure on the exchange rate, after 60 years of a fixed rate parity with the U.S. dollar, the Government of Guatemala in November 1984, introduced a three-tiered exchange system. Although the initiation of this new system brought the abolition of previous restrictions on imports, tourist travel abroad, and outward capital movements, its net effect on trade has been restrictive. In the official market, where the quetzal is still at parity with the dollar, the earnings from exports are insufficient to cover costs of "essential imports." The resulting shortages of petroleum products, fertilizer and other "official rate" inputs have impeded production in 1985. Even for products which receive an exchange incentive through the parallel market, the complexity and frequent, arbitrary changes of the system have sustained the currency black market in Guatemala.

B. Recent Macroeconomic Policy Reform Efforts

There were a number of efforts in 1985 to implement policy reforms to address the deepening economic crisis. This section provides, in summary form, the chronology of these attempts. A more detailed account is presented in Annex II. The chronology is instructive for two reasons: to illustrate the interplay and points of view shared among the different sectors of the economy on economic matters, and to preview the political challenge the new government faces as it comes to grips with Guatemala's serious economic problems.

The "April Package"

During March of 1985, the IMF came to Guatemala on their regularly scheduled Article IV consultation. Since the Government of Guatemala had fallen out of compliance with the terms of their adjustment program in 1984, they were anxious to negotiate a new stand-by agreement with the IMF which would have, they hoped, disbursed around $60 million in balance of payments support in 1985. Shortly after the team's visit, the Mejía Víctores government announced a comprehensive reform package primarily directed at improving Guatemala's revenue performance. The fiscal measures included a set of selective consumption taxes, a change in the valuation method of imports for the calculation of duties, a decrease in the number of commodities exempt from the VAT and export taxes on traditional products. Among other policy changes implemented at the same time were better export treatment for cotton and quota coffee, an increase in interest rates, increased reserve requirements and other limits on domestic credit expansion.

These new policies caught most Guatemalans by surprise and prompted a vociferous backlash from the private sector and the population in general. The opposition was so strong that it almost brought down the government, and the measures were rescinded only a few days later. Since no policy changes to deal with growing fiscal, monetary and external imbalances appeared to be forthcoming, the IMF decided that it would be inadvisable to initiate a new stand-by agreement.

The National Dialogue

With the failure of his April Package, the Chief of State placed the next move in the hands of the private sector. He announced the formation of the "Grand National Dialogue", which was an economic working group made up of leaders from the public and private sectors, including groups that had not been brought into policy discussions in the past, such as unions and cooperatives. After many meetings, on July 1, 1985 an economic policy reform package agreed upon within the working group was put into effect.

The set of measures represented compromise among all participating groups. The public sector agreed to make additional spending cuts. The private sector acquiesced to several new revenue measures, in particular a foreign exchange transactions tax, new selective consumption taxes, and an increase in the airport departure tax. In return, there was agreement that several important issues dealing with export red tape would be studied by the public sector. Several import commodities were moved from the official to the parallel markets. Labor received an agreement that the private sector would grant wage increases to the extent individual firms were able. Members of this group subsequently travelled to Washigton, D.C. to speak with U.S. officials and to request a second IMF visit.

Although these reforms were not far-reaching enough given the seriousness of the crisis, the National Dialogue represented a watershed in Guatemalan history, as it was the first time that economic policy was negotiated among representatives of most sectors of society.

The September Package

In late August, the government made yet another attempt at solving its economic problems by dealing with two heavily subsidized areas. The price of gasoline was increased by about 50 percent and bus fares were raised by 5 centavos. The gasoline increase, borne primarily by the middle class, was accepted without much protest. The lack of dissent reflected the publicity surrounding foreign exchange shortages and the late-summer sale of gold reserves to pay overdue oil bills. The intraurban bus fare increase, which had its most serious impact on the poor, incited much protest. The Chief of State, to prevent an escalation of civil disturbance and further bus burnings, rescinded the increase shortly after in went into effect.

At the same time, the Bank of Guatemala was in the process of formulating a more comprehensive stabilization package, to present to the IMF during their September visit. This package reportedly included measures such as unification of the exchange rate and new export taxes. The plan was approved by the Junta Monetaria, but ultimately rejected by the Chief of State. As it turned out, not only was there no economic plan to present to the IMF, but their visit coincided with the protests over the bus fare increases and with strikes in the Central Bank and the Ministry of Finance. The latter impeded the IMF team's work while in country. Thus, the hope for implementation of a stabilization plan in conjunction with a new IMF agreement in late 1985 was eliminated.

The Holding Package

In September, to quell the public disturbances over the bus fare increase and the rapidly rising cost of living, the government instituted a "holding package," which was intended to carry the country through until the new government assumed control in January. As part of this strategy, the bus fare increase was removed and replaced with an urban transport subsidy of around Q2 million per month. In addition, most public employees were granted a Q50 monthly salary increase. Wholesale and consumer prices on 40 products were rolled back to the June-July level and frozen there. Exchange houses were closed and a criminal penalty was established for dealing in foreign exchange outside of the banking system. This 'holding package' more than reversed the progress which had been made under the National Dialogue, particularly with respect to reducing the fiscal deficit.

According to the outgoing government, the holding package was the last set of measures to be taken during their administration. However, several positive steps were taken during the last weeks of the Mejía Víctores regime. Most importantly, the Rule 3 and selective consumption tax increases were decreed into law. An austerity budget for 1986 was passed and legislation establishing a new Ministry of Development, a priority of the new government, was published.

Conclusions

At first reading, the chronology presented in this section paints a highly pessimistic picture of the likely acceptance of an austerity program among the Guatemalan private sector and public at large. The policy reform attempts of 1985 nearly all failed, and several created serious political crises for the government in power. It would be incorrect to draw the conclusion, however, that there is no room for the new government to enact the economic reforms essential to renewed growth in Guatemala.

Rather, there are important lessons to be learned from 1985. First, the perceived legitimacy of the government in power is crucial in its ability to broker unpopular measures among the different interest groups within Guatemalan society. In this regard, the Cerezo government will be at a substantial advantage over its predecessor, having gained power with a nearly 70 percent plurality in fair elections, rather than through a coup. Much of the rejection of the economic measures attempted during 1985 was based on their being announced, with little advance notice or public debate, as decrees from the Chief of State.

Secondly, an education effort must precede the announcement of new policies, so that the population is psychologically prepared and understands the necessity of the proposed action. For example, there was little protest of the 50 percent hike in gasoline prices in 1985, as the public had been prepared through the publicity surrounding the foreign exchange gap and the need to sell national gold holdings to meet oil bills. The April package, by comparison, caught the private sector completely by surprise, as there had been little public preparation about the growing seriousness of the recession and the need for corrective measures. Many in the private sector mistakenly interpreted the fiscal measures as an attempt by the regime in power to increase the size of government.

Finally, the success of the Grand National Dialogue indicates that, if the private sector is brought into policy discussions, they are willing to accept austerity measures, even taxes. The problem in the recent past has been that there was no consultation with the private sector before economic measures were announced. This meant that for the private sector, the only recourse available was strong protest after the fact. Since the new government has tried, from the start, to bring the private sector leadership into the policy planning process, there will be less chance for a repeat of the type of protests seen after the imposition of the "April Package."

C. Role of the Private Sector

The role of the private sector has been briefly discussed in the preceding sections and its participation in the "National Dialogue" is detailed in Annex II. Further exploration of the private sector's contribution to economic growth and the effect on private sector production of the current economic crisis is essential to understanding the Mission's rationale for providing the GOG with needed balance of payments support.

As compared to the other Central American countries, the Guatemalan private sector plays a much more dominant role in the overall economy (an estimated 85% of GDP in 1985), as the public sector is small by both absolute and relative standards. Any effort to stimulate growth in Guatemala must focus on strengthening the private sector's ability to respond to market stimuli, both for production for the domestic market, and more importantly, for export. This latter will be key to Guatemala's progressive reduction of balance of payments deficits and ability to finance future investment from domestic, rather than externally borrowed, resources.

Of all the Central American countries, Guatemala was most capable of taking advantage of the opportunities afforded by membership in the Central American Common Market (CACM). As a result, the Guatemalan productive sector maintained constant growth throughout the 1960s and 70s. As trade within the CACM was disrupted in the early 1980's, Guatemalan industry stagnated, since its productive infrastructure was geared to protected regional markets and based on import-substitution. Most of its manufactures were not competitive in the larger trading world. With a growing foreign exchange scarcity, the stagnation turned into near-zero or even negative growth in each of the past four years. The agricultural sector was generating foreign exchange surpluses while the industrial sector could only be profitable at an artificially overvalued exchange rate for imported inputs. Since non-petroleum raw materials for the manufacturing sector account for 53% of total imports, growth of the private sector economy in the near-term will require sufficient availability of foreign exchange to pay for inputs to production which are not produced domestically. In the longer term, a comprehensive stabilization package will correct price distortions endemic throughout the economy which discourage, rather than encourage, the shift of productive emphasis to export to international markets.

The strong private sector outcry to the April policy reform package raised questions about their willingness to accept the reorientation of economic policy to encourage exports, and to end the chronic tendency to balance of payments deficits financed by commerical borrowing. These issues have been reviewed in previous sections of this document. What is important to note here is that the private sector has been seriously hurt in the economic crisis, and stands to benefit substantially from a more rational policy framework. The exchange rate system, to cite one example, in effect provides for a heavy (up to 60 percent) direct tax on gross sales, depending on the product's exchange treatment. The inability of many producers to gain access to credit, a result of interest rate policies among other factors, represents another substantial constraint on private sector growth.

In the collaborative spirit of the Grand National Dialogue, various subgroups of the organized private sector have engaged in discussions with the outgoing and incoming governments toward rationalizing policies more in support of productive growth. In one such effort, the Association of Nontraditional Exporters has identified constraints to the promotion of the products of their membership and has presented a plan which would generate an increase in nontraditional exports from an expected $172 million in 1986 to $500 million per year by 1989. The Mission is working closely with this group in providing financial and technical assistance for the promotion of their products in international markets. The expectation is that with the new government's willingness to include the private sector in the formulation of policy, a spirit of compromise can be cultivated within which the private sector will benefit from a macropolicy framework more conducive to growth. While there may be some dissent from groups whose short-term profits lie in production for highly protected domestic markets, the majority will tangibly come to realize that reorientation of the economy is to everyone's benefit. The leadership of the private sector are now strong advocates of a comprehensive stabilization program.

4. PROSPECTS FOR ECONOMIC GROWTH IN 1986 AND 1987

A. Guatemala's Development Problems and Relationship to CAI Objectives

The usual approach to presenting the constraints to economic growth is examination of sectoral policies in the monetary, fiscal and exchange areas. This introduction departs temporarily from the traditional framework to place the analysis of the structural problems of the Guatemalan economy in the context of the objectives of the Central American Initiative, namely 1) economic stabilization, 2) restructuring of the Guatemalan economy to promote self-sustaining export-led growth, and 3) greater participation of the rural and urban poor in that growth. The fourth objective, strengthening democratic institutions, is not an economic goal per se, but helps provide the stable political climate in which consensus for economic policy reform can be achieved and investor confidence bolstered.

The constraints to Guatemalan economic growth can thus be considered on three levels. First, there are basic policy weaknesses in the fiscal, exchange and monetary areas which represent inadequate responses to the external shocks of the late 1970s and early 1980s. These weaknesses have propelled the economy into negative growth and a deepening state of external imbalance by encouraging a greater level of import demand than the country's export earnings can sustain. They include, most importantly, the subsidies and export disincentives inherent in the multiple exchange rate system, the growing tendency to fiscal deficit and the policy of interest rate controls which encourages substitution of external borrowing for reliance on domestic savings. Since even immediate policy responses to correct these problems will have lags in their effects on economic variables, balance of payments assistance is justified in easing the short-term social and political costs of an austerity program.

The second level of constraint deals with the restructuring of the Guatemalan economy in line with the newly changed set of relative prices which imply that imports are costlier and exports more profitable, especially for nontraditional products to extraregional markets. The drastic change in relative prices implied by unification of the exchange rate is a necessary, but not a sufficient condition for the strengthening of Guatemala's export sector. Additional support to the reorientation of the Guatemalan economy will be required in the development of a suitable policy framework, the dismantling of regulatory impediments and the investment of public and private resources in infrastructure and programs to support export-led growth.

A third level of constraint involves the low productivity of Guatemala's disadvantaged groups, both urban and rural, which stems from the lack of investment in human capital, particularly in the areas of education, job training and health. Development of export industries, especially in the agricultural area where Guatemala has a comparative advantage, will require farmers who have the capacity to adapt new technologies and new products. Expansion of competitive light manufacturing and assembly industries to meet CBI incentives similarly will require a high-productivity work force. Investments in human productivity have traditionally received limited attention in Guatemala, with the result that the Guatemalan population has some of the lowest levels of educational and health achievement in the hemisphere. Improvements in this area will be necessary if Guatemala is to achieve self-sustaining growth. Donor support will be critical in accelerating the pace at which Guatemala can "catch up" in these areas.

The specific economic policies, by sector, which constrain growth and development in Guatemala are discussed below and in Annex I.

Structural Constraints to Economic Growth

Fiscal Policy

Historically, Guatemala has employed conservative fiscal policy. The country is atypical of most developing nations in possessing neither a large public sector, nor an onerous tax burden, nor even extensive parastatal enterprises which drain large amounts of funds from the Central Government. The fiscal constraint to economic growth in Guatemala is the inadequate level and type of public sector spending, and the lack of tax revenues to support even these minimal expenditures. As will be discussed below, there is a need to combine traditional fiscal discipline with wide-ranging and politically enforceable tax administration reform measures. These policies should go hand in hand with a more concerted focus of public sector investment activities on projects which support development, particularly in rural areas.

Since 1980-81 when Guatemala entered its current recessionary period, revenues and expenditures as a percent of GDP have consistently declined. The extent of the collapse of the revenue system (the reasons for which are discussed in detail in Annex I) has been masked by a corresponding drop in expenditures, with the result that the fiscal deficit has been maintained at a fairly low level (1.8% of GDP in 1985 as shown in Table 2). The public spending cutbacks have reached a point where even rudimentary maintenance of public infrastructure has been neglected. Public sector real wages have fallen drastically over the past decade, with the result that it is becoming increasingly difficult to attract and retain capable civil servants to carry out the nation's business.

The area which has been the hardest hit during this period of economic decline is capital expenditures. The level of public investment has fallen from a high of 7.6% of GDP in 1981 to a low of about 1.8% for 1985, and a projected 2.5% for 1986. Initially, large capital intensive projects, such as hydroelectric power sites, were either scaled down or cancelled altogether. However, the most recent budget cuts have centered on school and health facilities and road maintenance. Cuts in these areas are having a deleterious effect on rural development and on programs to increase productivity and incomes of disadvantaged groups. If needed public investment is not undertaken, and maintenance of previous investment is neglected, there will be costly and irreversible damage to the country's public infrastructure.

The new government faces a formidable task in improving Guatemala's fiscal management. The problems inherent in the tax system are complicated by its general inelasticity. As inflation has accelerated, revenues have not kept pace. On the other hand, expenditures are growing in proportion to general price level increases. What this means is, even without increased expenditures, there will be a tendency to a widening fiscal deficit in 1986. The incoming leadership will have to move quickly and effectively to maintain spending discipline and increase revenue generation within the system. In the absence of such action, the 1986 fiscal deficit could be as much as 2 1/2 times greater (as a proportion of GDP) than that of 1985.

External Balance

Guatemala has suffered a chronic balance of payments problem throughout the 1980s, as shown in Table 3. The tendency to external deficit has been aggravated by expansionary economic policies in the early part of the decade, and more recently by the inability of the current multiple exchange rate system to generate and allocate foreign exchange in a manner which supports a growth-producing level of imports and exports.

16-Jan-86

Table 2

GUATEMALA:
FINANCIAL OPERATIONS OF THE CENTRAL GOVERNMENT
1980 - 1986

	1980	1981	1982	1983	1984p	1985e	1986e
CURRENT ACCOUNT	93.2	13.0	19.8	19.9	-100.2	-5.4	-135.0
Revenues	747.3	740.6	729.8	741.1	666.3	818.9	975.3
Expenditures	-654.1	-727.6	-710.0	-721.2	-766.5	-824.3	-1110.3
CAPITAL ACCOUNT	-461.7	-650.6	-430.2	-315.2	-260.8	-216.0	-421.6
Revenues	0.7	1.8	1.3	1.7	2.4	2.1	1.7
Expenditures	-462.4	-652.4	-431.5	-316.9	-263.2	-218.1	-423.3
OVERALL BALANCE	-368.5	-637.6	-410.4	-295.3	-361.0	-221.4	-556.6
External Financing, net	92.9	102.1	95.2	80.4	22.9	14.8	143.7
Internal Financing, net	275.6	535.5	315.2	214.8	337.9	206.6	412.9
Memo Items:							
Deficit as % of GDP	4.7	7.4	4.7	3.3	3.7	1.8	3.3
Investment budget as % of GDP	5.9	7.6	5.0	3.6	2.8	1.8	2.5

Source: Banco de Guatemala, IMF

Note: Public sector budget does not include the impact of the following early January policy measures:
-Increased expenditures to fund possible 3 new ministries
- Revenue increases from Rule 3 and selective consumption taxes

In the early 1980s, the quetzal, fixed at parity with the dollar for more than 60 years, became increasingly overvalued. This exchange policy artificially encouraged imports, and discouraged production for extraregional markets. In November of 1984, the Government of Guatemala made an effort to correct tne imbalance by establishing a parallel market where the quetzal could float freely. Unfortunately, the new system, instead of improving the situation, has in some respects made trade even less attractive. The complex system has three legal exchange markets: the official market in which one quetzal is still equivalent to one dollar, the parallel or banking market where the rate is established by supply and demand, and less importantly, the auction market where foreign exchange is sold to the highest bidders among importers of certain designated commodities.

The list of imports selected for special treatment in the official market is small but contains in value terms 40% of all imported products. These include politically sensitive items such as petroleum products, wheat, medicine, fertilizer, and agricultural hand tools. However, the inclusion of petroleum products and the maintenance of debt service in this category provided a substantial payments gap for the government to meet in 1985. On the export side, foreign exchange treatment varies by product and product destination, with a complicated and frequently revised set of effective exchange rates.

Guatemala has also suffered a reduction in intraregional exports and is turning to other markets. This is primarily due to the deterioration of the CACM, and to the mounting debt among the member countries (described in Annex III). A substantial portion of Guatemala's reported international reserves is accounted for by trade debt the country is owed from its Central American neighbors.

Monetary Policy

The key problems in the monetary sector have been excessive expansion in the money supply due to the financing of the fiscal deficit and the Central Bank exchange losses, and the interest rate ceilings which have kept real rates highly negative. The first set of problems is discussed earlier and in Annex I. This section considers Guatemala's interest rate policy.

The maintenance of commercial bank interest rates at fixed levels which, in real terms, lie below those prevalent in the international financial community, combined with low levels

TABLE 3

GUATEMALA: BALANCE OF PAYMENTS

	1982	1983	1984	1985e	1986e a/
Current Account Balance	-371.1	-223.9	-377.3	-331.3	-200.9
Trade Balance	-188.4	35.7	-49.9	-16.6	46.6
Exports	1199.6	1091.7	1132.2	1123.4	1300.6 b/
Imports	-1388.0	-1056.0	-1182.1	-1140.0	-1254.0
Services/Transfers Net	-182.7	-259.6	-327.4	-314.7	-247.5
Capital Account Balance	-14.8	321.8	400.5	396.3	-256.4
Private Net	-289.5	51.8	12.1	273.7	-53.5
Official/Banking Net	274.7	270.0	388.4	122.6	-202.9
Errors and Omissions	-7.6	-8.6	-15.5	0.0	0.0
Unfinanced Gap	0.0	0.0	0.0	-65.0 c/	392.3 d/
Net International Reserves including arrears (millions of U.S.$)					
Banking System	-295.1	-301.7	-518.3	N/A	N/A
Banco de Guatemala	-266.9	-235.8	-422.3	N/A	N/A
Memo Items					
GDP in current Q's (millions of Q's)	8728.0	9035.0	9457.4	12224.7	17346.5
GDP Deflator	5.1	6.5	3.6	30.9	39.8
Guatemalan Exports to U.S. Percent of Total	26.4	32.9	39.0	N/A	N/A

a/ Assumes 1.5% real growth in 1986.

b/ Assumes average 1986 coffee price of $203 per quintal (ANACAFE projection). Each additional $10.00/quintal increase reduces the financing gap by about $28 million. For other assumptions about 1986, please see text.

c/ Negative indicates a surplus.

d/ Assumes that 1985 BOP surplus is applied to 1986 financing gap.

Source: Bank of Guatemala, USAID estimates.

Note: Official capital figures for 1986 do not include C.C.C., AID Exim-TCIP credits or ESF funds. Nor are included inflows from the IMF and World Bank.

of confidence, has exacerbated the shortage of capital in the domestic economy. An increase in the interest rates which banks are allowed to pay (the current ceilings are 9% for time deposits and 12% for loans) to positive real rates would encourage domestic saving. A higher level of domestic savings would, in turn, divert some money from import demand, and reduce the preference to hold dollars as a store of value. Greater interest rate flexibility in response to domestic price movements would provide some protection for savers and help to channel scarce resources into more economically rational investments.

Pricing Policies

In the past, Guatemala has experienced relatively moderate rates of inflation which were caused for the most part by external factors. However, in 1985, inflation accelerated due to the depreciation of the quetzal parallel rate and the expansion of the money supply implicit in the fiscal deficit and the Central Bank exchange losses. The December 1984 to December 1985 rate of increase in the price level is projected at 35%, and in the absence of early implementation of a strong adjustment program in 1986, inflation of more than 40% is expected.

To combat these inflationary trends, price ceilings were imposed on many basic products by the government in September 1985. At best, price controls represent a short-term palliative to relieve inflationary expectations. They have made many products unprofitable to manufacture for sale in Guatemala and have stimulated contraband and black markets. In the long run, it is clear that inflation can only be controlled by attacking its fundamental causes through an economic stabilization program.

Numerous pricing subsidies exist within the Guatemalan economy, primarily as a result of the foreign exchange system. The exchange regime grants a generous subsidy to a diverse group of products and services, including gasoline, kerosene, electricity, telephone services, fertilizer, pesticide, medicine, and imported wheat. Movement toward unification of the exchange rate is the most direct policy prescription to end this set of pricing distortions.

B. Balance of Payments Gap and the Need for Compensatory Financing

Table 3 and Chart 1 show Guatemala's balance of payments for 1986. At a target 1.5% growth rate, the financing gap is estimated at $392.3 million. At the Government of Guatemala's estimated 1986 real growth rate of -1.5%, their projection of the financing gap is only about $160 million, due to the lower import requirements implied by this diminished level of national production.

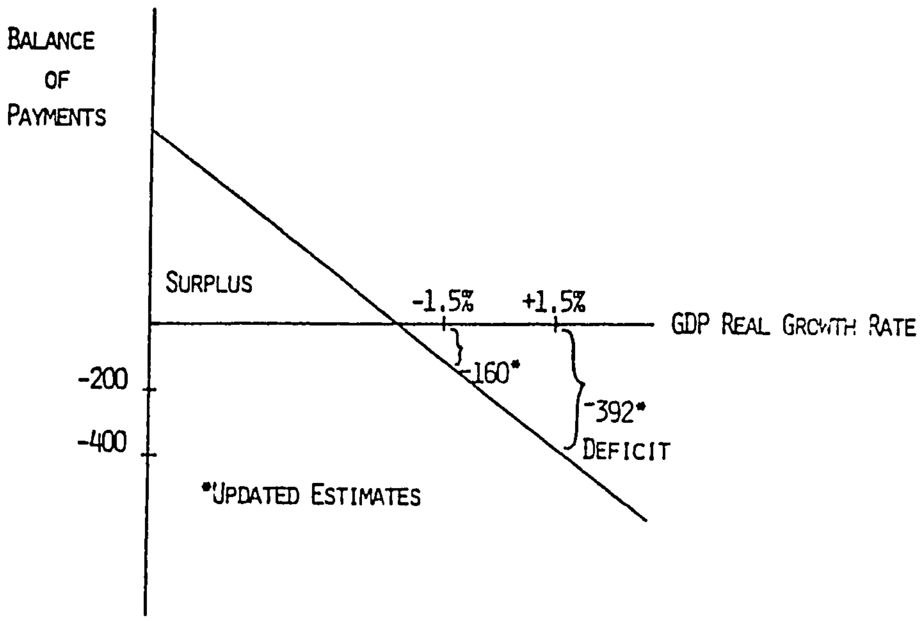
The balance of payments figures for 1986 have been revised to reflect the best information currently available on the impact of rising coffee prices. 1/ Based on figures of the national coffee producers' association, ANACAFE, the average price per quintal of coffee exported in 1986 is projected to be $203. Each additional $10 increase per quintal over this level would imply -ceteris paribus- a $28.0 million reduction in the gap. However, $150 million in advance payments for 1986 coffee imports were repatriated in 1985, according to the Central Bank. Of this amount, only $65 million remains unspent to be applied to the 1986 balance of payments gap. The Guatemalan government has, as of the date of this document, published no official estimates of the impact of the coffee price rise. When such figures are available, they will be cabled to AID/W.

The estimates of Guatemala's financing gap are based on some additional assumptions. Petroleum export statistics for next year are highly unpredictable. Estimates for 1986 for Guatemala vary from about $12 million to more than $40 million. The optimistic estimates are based on a presumption of increased production from new wells. An intermediate value of $30 million was assumed. A moderate (5%) increase in exports to CACM countries is assumed. If trade impediments within the region are solved, this increase could be even higher. Each one percent increase in exports to Central America over 1985 implies a $2.5 million reduction in the financing gap.

1/ The balance of payments figures do not incorporate the effects on imports of changing petroleum prices, and of Rule 3 and the new selective consumption taxes, which occurred after this document was completed.

CHART 1

BALANCE OF PAYMENTS GAP - GUATEMALA (1986)



The balance of payments gap is larger at higher real growth rates because production is dependent on inputs which cannot be produced domestically. At the same time, the ability to "fill" an external financing gap will determine the rate of GDP growth the country is able to achieve. The graph above illustrates the estimated relationship for Guatemala between growth and imports. At the Government of Guatemala 1986 real growth estimate of -1.5%, the financing gap is projected at about $160 million. At a target growth rate of positive 1.5%, the gap will be much larger at $392.3 million, since to achieve that growth level, imports will need to be much greater.

IDB trade credit programs, which up until now have not been tied to a stabilization package, are considered an "above the line" item and are taken into account in calculating the 1986 gap. External financing sources added "above the line" in the gap calculations, however, do not include potential financing from the U.S. Government, the IMF or the World Bank. These are listed below.

TABLE 4

POTENTIAL EXTERNAL FINANCING OF BOP GAP - 1986

Source	Term	Rate	Potential 1986 Level
U.S. Government			
Economic Support Fund	Long	Conces.	$ 75 million
P.L. 480 Title I	Long	Conces.	$ 20 million
AID Exim-TCIP Credits	Short	Market	$ 75 million
C.C.C. Credits	Medium	Market	$ 45 million
Total USG BOP Support			$215 million
International Monetary Fund			
Stand-By Agreement	Medium	Below Market	$ 60 - 80 million
World Bank			
Export Credit Program	Long	Below Market	$ 75 - 100 million
Donors/Commercial Banks			
Potential Debt Reschedul.	Short-Medium	Market	$100 - 200 million
TOTAL POTENTIAL EXTERNAL FINANCING			$450-$595 million

Import estimates are based on historical requirements, with adjustment to reflect lowered demand due to a more expensive dollar (in quetzal terms). The successful operation of Chixoy at full power by March 1986 will imply a $60 million reduction in the petroleum bill over 1985, another import assumption.

On the capital account, official inflows include only those which Guatemala will receive regardless of whether a stabilization program is imposed. Since this is an early estimate for 1986, official capital inflows appear much lower than for 1985, as financing sources have not been fully lined up yet. Inflows which are in place as this document is written include two IBD trade credit programs (Industrial and Agricultural Reactivation) and petroleum credits from Mexico and Venezuela. U.S. assistance from ESF, AID Exim-TCIP credits, CCC credits and P.L. 480 are not included in the capital account estimates, but rather are considered potential sources of financing to fill the gap. The same classification was given to IMF financing and World Bank trade credits, which can also be termed extraordinary financing for balance of payments support.

Debt service payments are divided between the current and capital accounts, with interest included in the former under services and principal in the latter. Service on the public external debt will amount to more than $630 million in 1986, with the exact amount unclear. (A summary of debt service obligations for 1986 is shown in Table 5.) This imprecision in the data is due to the fact that there were several *ad hoc* financing arrangements for petroleum in the last quarter of 1985 whose terms have not yet been made public.

An additional capital outflow item for 1986 reflects the advance payments or borrowing made on the value of the 1986 coffee crop which were received in 1985. As noted earlier in this section, the impact of higher coffee prices has been muted for 1986 because much of the gain was borrowed at the end of 1985 to meet last year's balance of payments gap.

Finally, the balance of payments estimates are based on the assumption of no response to policy changes in 1986. If, however, a stabilization program is initiated early in the year, austerity measures and higher prices for imports which now receive official market (Q1.00 per $1.00) treatment could reduce import demand below that shown. Early implementation of stabilization measures would serve to reduce the 1986 gap and lower the required level of external financing. Put another way, a stabilization program effected in the very near future could produce for Guatemala a higher rate of growth than that implied in Chart 1.

TABLE 5

Guatemala - Public External Debt Payments
(1986 by Quarter)
('000 U.S. $'s)
***

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	TOTAL
TOTAL DEBT SERVICE	123019	174998	208845	123994	630856
CENTRAL BANK	98349	121807	181980	70013	472149
-short-term (0-1 yrs)	8050	35123	10500	63	53736
-medium-term (1-5 yrs)	88560	80302	170075	64283	403220
-long-term (more than 5 yrs)	1739	6382	1405	5667	15193
CENTRAL GOVERNMENT	12546	20280	13687	22177	68690
AUTONOMOUS ENTITIES	11420	31327	12434	31200	86381
-INDE	7119	11107	7760	11066	37052
-GUATEL	1049	2253	1048	2332	6682
-BANVI	872	1020	918	1345	4155
-CORFINA	1734	16947	1688	16457	36826
-FEGUA	403	0	778	0	1181
-Univ. Rafael Landivar	243	0	242	0	485
MUNICIPALITIES	704	1584	744	604	3636

Distribution by Quarter

	Principal	Interest	Total	Percent of Annual Total
1st Quarter	90560	32459	123019	19.50%
2nd Quarter	126698	48300	174998	27.74%
3rd Quarter	178704	30141	208845	33.11%
4th Quarter	79626	44368	123994	19.65%
TOTAL	475588	155268	630856	100.00%

The potential sources of financing of the estimated $392.3 million balance of payments gap are summarized in Table 4. Several points can be made here. First, assistance from the U.S. alone cannot meet Guatemala's financing needs. Second, the gap can be feasibly filied and a positive level of growth achieved if an economic program is put together early in 1986 and if support is forthcoming from the other international donors and the commercial banks in providing new credit and rescheduling debt payments which come due this year. Finally, financing gaps of the magnitude described will continue beyond 1986 if stabilization policies are not put into place fairly soon. Early implementation of a credible and comprehensive stabilization program by Guatemala's new government will be urgently required if Guatemala is to avoid another year of negative real growth.

5. Program Description

A. U.S. Interests and CDSS Relationship

The FY 1986 Country Development Strategy Statement (CDSS) drew a portrait of Guatemala as a country with considerable natural endowments and economic potential, sharply contrasted with the reality of severely unbalanced distribution of income and a very high level of actual poverty, particularly among the indigenous population. This situation prevailed through most of Guatemala's modern history with little evidence of any real commitment until recently to equality of opportunity for the indigenous population. During most of the 1960s and 1970s, Guatemala experienced high economic growth rates but with only small gains in the standard of living for the indigenous population and other rural poor. Since the late 1970s, the nation has found itself caught in a serious economic decline resulting from inadequate policy responses to external shocks such as the world oil price hikes of the 1970s, the stagnation of Central American Common Market (CACM) activities, the generally low world prices paid for Guatemala's major exports and the paralyzing effects of the major insurgency experienced in the early 1980s. The data and narrative provided earlier and expanded on in the annexes highlights the danger that, in the absence of an economic adjustment program, Guatemala's current economic problems could become long-term structural constraints rather than temporary phenomena. In this recessionary climate both growth and equity suffer, and regional security as well as Guatemalan stability are endangered.

Responding to social, political, and economic problems afflicting the region, the Kissinger Report, emanating from the work of the National Bipartisian Commission on Central America (NBCCA), has motivated a rapid build-up in levels of economic assistance to the Central American region.

Because of Congressional concerns about Guatemala's commitment to human rights and development, levels for Guatemala have until now lagged well behind those for Honduras, Costa Rica and El Salvador despite Guatemala's much larger population and resource requirements. However, as noted previously, political conditions have improved substantially in past years. With the restoration of an elected civilian government pledged to improve social welfare and to end human rights abuses, the stage is set for effective use of much higher levels of aid to Guatemala, including badly-needed balance of payments (BOP) assistance. Central to the prospects for success of such assistance is the development and introduction by the Government of Guatemala of a comprehensive policy reform package to underwrite economic recovery. U.S. BOP assistance will be targetted to support such actions. Although Development Assistance (DA) inputs are directed at specific development sector growth and removal of procedural and regulatory constraints to growth, such as in agriculture, education, health, and small business development, they are and will continue to be closely linked to the larger macroeconomic policy reform agenda. The strategy and rationale outlined in the FY 1986-1987 Action Plan and in the FY 1986 CDSS continue to be an accurate statement on which both ESF and DA program planning and implementation activities are based.

B. Program Justification/Objectives

Central to the turnaround in the Guatemalan economy is a greater availability of foreign exchange to maintain access to necessary imported fuels and inputs. The movement toward democracy and away from political violence will be endangered by a protracted recession. The provision of a meaningful level of assistance at this critical point would assist in a Guatemalan economic recovery and also would serve important U.S. interests.

The objectives of USAID's FY86 balance of payments program are:

--to restore Guatemala to a path of positive economic growth;

--to support the adoption of politically difficult fiscal, monetary and exchange measures;

--to encourage the substitution of domestic savings for external borrowing;

--to promote greater public support to the process of economic growth and development, particularly in rural areas where a situation of social injustice is manifestly evident; and,

--to assist the Government of Guatemala's support of the private sector, and particularly the export sector.

The success of these objectives will reduce Guatemala's future need to rely on compensatory external financing sources by diminishing the economy's tendency to chronic balance of payments gaps.

Balance of Payments Support

The provision of the requested level of funding would provide USAID with fast-disbursing BOP support monies which would assist in meeting Guatemala's critical shortage of foreign exchange. USAID therefore proposes that all ESF disbursements in FY 1986 be made via the cash transfer mechanism. The potential benefits of a cash transfer are substantial in promoting the adoption of urgent but politically difficult policy reforms.

The disbursement of this assistance through a Commodity Import Program (CIP) would limit the effectiveness of the resources available to meet this crisis and would weaken USAID's leverage in pushing for policy reforms. A CIP would gain no additional benefits, as the U.S. is Guatemala's primary supplier of imported goods by far, in quantities whose value greatly exceeds the level of proposed ESF assistance.

Cash Transfer Mechanism and Disbursement Procedure

The initial allocation of $24,925,000 ($23,925,000 loan and $1 million grant) will be disbursed in its entirety upon satisfaction of the conditions precedent to disbursement. Funds will be transferred electronically by AID/W into the Bank of Guatemala's account in the Federal Reserve Bank in New York. Later FY 1986 tranches will be disbursed upon evidence of further progress in meeting adjustment program goals.

C. Components of a Stabilization Policy Package for Guatemala

The constraints to growth facing the Guatemalan economy have been described in previous sections of this document and in Annex I. It is essential that USAID's ESF resources are lined up squarely behind a credible and comprehensive stabilization program on the part of the incoming government. It is also essential that the substance of such a program be agreed on early in the negotiations. Table 6 illustrates the interrelatedness of Guatemala's economic problems, and identifies the steps which must be taken to correct these distortions and disincentives to production and export.

In the Mission's view, an ESF program that targets selective policy reforms to trade for disbursement of funds would have limited effect, given that current economic policy weaknesses extend through all sectors of the economy. In addition, there would be a message sent that isolated measures identified by donor agencies have a greater urgency than implementation of a comprehensive, well-designed policy package. For example, unification of the exchange rate in absence of fiscal measures could widen the fiscal burden, given the large public external debt service due this year. A comprehensive economic program, which targets the fiscal, monetary and external sectors, and which provides for an equitable sharing of the burden of austerity among the different sectors of the economy, will contribute in a more immediate and more far-reaching way to Guatemala's economic recovery, and will be more likely to attract the needed support from other international donors and the commercial banks.

As outlined in Table 6, a comprehensive stabilization program for Guatemala should include movement toward unification of the exchange rate, reduction in the fiscal deficit without excessive sacrifice of programs in support of development, increased reliance on domestic savings through liberalization of interest rate policy, and dismantling of the pricing distortions implied in both the exchange system and commodity price controls.

The Mission proposes that start-up of the ESF program in 1986 be linked to a written request from the Guatemalan Government for balance of payments assistance which outlines in satisfactory fashion their planned stabilization program for the coming year. Disbursement of the first tranche will be triggered by the implementation of initial steps of the program. Other resources will be made available in FY 1986 and FY

1987 to support additional steps taken and progression from fundamental measures to stabilize the economy during the immediate crisis to greater emphasis on a long-term policy climate to foster productivity and growth.

Any stabilization package implies a cost in terms of economic austerity. Guatemala's poorest groups have already been severely hurt in the recession, through burgeoning inflation and high unemployment. It is important, therefore, that all sectors of Guatemalan society share the burden of the economic stabilization program, not just the country's less privileged groups. The positive effects of the national development program (including donor activities) are endangered by the economic downturn and by a reduced government ability to provide counterpart funds. In response, ESF local currency resources will be targetted toward reenergizing private sector growth opportunities and toward projects that sustain the development program objective of increased incomes and opportunities for the rural and urban poor. Planned uses for local currencies are described in greater detail in Section VI of this document.

Elements of An Economic Stabilization Program for Guatemala

A. Symptoms of Economic Policy Problem:

Symptom:	Root Cause:	Policy Prescription:
I. Inflation	Corrective Inflation - caused by depreciation of quetzal in parallel market.	Restrain pressure on quetzal through fiscal and monetary policies which reduce demand for imports, encourage capital inflows.
	Noncorrective Inflation - caused by excessive monetary expansion due to fiscal deficit and exchange losses of the Central Bank.	Increase revenues through better tax administration and steps to increase tax system elasticity.
		Maintain noninflationary level of credit expansion by Central Bank.
		Eliminate exchange losses through exchange rate unification.
II. Disorder in Foreign Exchange Market	Overly complex and arbitrary foreign exchange system leading to resource misallocation.	Simplify through unification.
		Eliminate exchange system "taxes and subsidies" or replace these with fiscal measures.
III. Scarcity of Foreign Exchange for Producers	High debt service requirements in 1985 and 1986.	Renegotiation of external debt through Paris Club rescheduling (normally requires IMF agreement).
	Structural deficit in official (Q1 per $1) market.	Eliminate deficit by placing more import transactions in parallel market, and ultimately through unification.
	Lack of access to international sources of finance for balance of payments deficits.	Implementation of a credible economic program which improves ability to meet current debt payments.
IV. Insufficient Investment and Capital Flight	Political instability, both internal and external (Nicaragua's Sandinista regime and its policy of exporting revolution); inconsistent and frequently revised economic policy.	Restore confidence through credible, comprehensive stabilization program which should include greater reliance on a responsible private sector and particularly on the development of non-traditional export-oriented industries.
	Interest rate policy discourages savings, encourages speculation.	Greater flexibility and market orientation for interest rates to savers and borrowers.
V. Lack of Opportunity for Rural and Urban Poor (especially in health care, education and employment)	Insufficient public sector investment in human capital and physical infrastructure, especially to increase economic endowments of the urban and rural poor.	Increased public sector investment in favor of equity and development.
		Increased employment through increased private sector investment and growth.

TABLE 6
Page 1 of 2

B. Summary: Comprehensive Guatemala Stabilization Program

A credible economic stabilization program incorporating:

(1) Reduction in the fiscal deficit through expenditure restraint and higher revenues,

(2) More market-oriented pricing policies for goods and capital (interest rates),

(3) Unification of the exchange rate,

(4) Rapprochement with the IMF and external debt renegotiation.

(5) Greater reliance on private sector investment and the promotion of export-oriented industries.

Plus greater emphasis on equity and participation for the urban and rural poor through:

(1) Reduction in inflation to pre-1985 levels,

(2) Increased public investment in education, health care and rural development, and

(3) Increased employment through higher private sector investment levels and policies which improve productivity and expand export incentives.

REQUIRED SUPPORT TO THIS EFFORT:

U.S. Government:

(1) Balance of payments support in 1986 and 1987,

(2) Local currencies and some DA used to support public sector investment,

(3) CCC, TCIP credits and PL 480, Title I assistance,

(4) Technical assistance in design and study of economic policy.

Other donor support will also be essential:

(1) An IMF program, to provide additional resources and pave the way to debt rescheduling,

(2) A World Bank Export Promotion Project followed by a Structural Adjustment Program, to also help meet balance of payments gap,

(3) Continuing economic reactivation project assistance through the IDB.

(4) Rescheduling of 1986 debt service payments.

D. Negotiating Strategy and Options

The substantive contents of a policy reform agenda have been outlined in earlier sections. This section concentrates more on the formation of the negotiating team on the U.S. side, identification of appropriate Guatemalan counterparts, and coordination of the dialogue with other international donor groups such as the IMF, the World Bank and the IDB, and with private banks. The discussion will also briefly consider ways to ensure adequate consultations with Guatemala's business and labor leaders.

The U.S. negotiating team will be led by the USAID Director. The team will also include the Embassy Economic Counselor and the USAID Program Economist. Positions to be taken and terms of negotiations will be cleared for Country Team purposes in prior discussions between the USAID Director and the Ambassador and the DCM and by joint State/AID cables with Washington.

USAID's LAC Bureau will coordinate and ensure clearances of all other Washington agencies, as appropriate. Data collection and analysis and preparation of position papers, as well as day-to-day relationships with key Guatemalan contacts such as in the Central Bank, the Ministries of Finance and Economy and the National Economic Planning Council, will be principally the responsibility of the USAID Program Office working with the Economic Counselor.

A principal objective will be to ensure that the USAID Director together with the Ambassador and DCM have full counterpart relations with the highest ranking Guatemalan Government officials managing the economic decision process. Discussions and coordination with other international donors and private bankers, as well as with private sector and labor leaders, will be managed by members of the negotiating team or other Mission staff personnel as instructed by the USAID Director or the DCM.

The policy dialogue will be bolstered with technical support in the analysis of economic policy options. The contracting of economic policy studies will be funded with $500,000 of the grant portion of the FY 1986 ESF allotment. As appropriate, studies will be carried out through local or U.S. economic consultants, or through TDY assistance from AID/W or the other Central American Missions. Technical assistance to the new Government of Guatemala in policy studies will be supervised jointly by the USAID Program Office and appropriate counterparts in the economic ministries.

Given the pivotal role of the Guatemalan private sector, the Mission will work closely with the new government's team to ensure continued and adequate representation for policy formulation by the private sector and cooperation in implementing decisions. Although the precise mode of such discussions remains to be determined, this requirement has been discussed with both public and private sector economic team leaders on the Guatemalan side and initial agreement has been reached on the need to continue such consultations.

6. LOCAL CURRENCY STRATEGY

As earlier pointed out in this document and in the FY 1986-87 Action Plan's Policy Dialogue Section, USAID/Guatemala sees two related, but distinct policy agenda areas that must be addressed if U.S. assistance is to be effectively leveraged toward achieving the larger goals of democratic government, economic recovery and growth with equity. These two areas are: macroeconomic policy reform and specific development sector reforms. The former is central to Mission ESF and economic recovery planning. The latter relates more directly to existing and planned DA inputs. Although discrete in many aspects, both are interlinked by the overriding program objectives of growth with equity and by their implications for specific allocations of available resources. The problems of covering both areas are the more difficult given the shrinkage of public sector spending resulting from efforts to close the fiscal deficit.

The close coordination necessary to sustain both the development assistance and balance of payments programs will be reinforced by jointly programming available Title I and ESF local currencies with the Guatemalan Government toward such activities as support the longer term development and growth with equity goals. In the event there are still funds after the establishment of the planned OE trust fund and provision of USAID project counterpart, consideration will be given to financing the local currency costs of World Bank and IDB projects complementary or compatible with USAID's larger goals. The following sections provide more detail on planned local currency uses.

1. Local Currency Program

Immediately following disbursement of $23,925,000 million in loan funds and $1 million in grants (an additional $500,000 grant will be retained to fund foreign exchange costs of jointly agreed-upon economic studies), the GOG will establish a fund in the Bank of Guatemala for an amount of quetzales equivalent to the amount of dollars disbursed under the loan portion of this agreement. The rate of exchange to be the highest rate of exchange which, at the time the deposit is made, is not unlawful in Guatemala. The Dirección de Financiamiento Externo (DFE) of the Ministry of Finance will be responsible for administering this fund, although all financial transactions will be the responsibility of the Bank of Guatemala. The USAID Mission and the GOG will mutually program the local currency fund. Once programmed and approved, funds will be released by the Bank of Guatemala from the master account to a project-specific account in the name of the implementing agency. Simple disbursement procedures will be established for release of funds from these project accounts to the implementing institutions. The DFE will monitor project implementation and post-audit disbursements for the projects to verify compliance with the approved financial and implementation plans.

2. Planned Local Currency Uses

The Mission currently expects the local currency fund created by the Government of Guatemala under the grant and loan portion of this program to be used for activities similar to those described below:

i. Operating Expense Trust Account. The local currency fund created by the Government of Guatemala with one million dollars of grant funds will be used to open an Operating Expenses (OE) trust account. The Mission plans to negotiate this Trust Account with the GOG in accordance with the General Agreement for Economic, Technical and Related Assistance between the Governments of the United States and Guatemala. The Trust Account will be established in the name of the U.S. Disbursing Officer and shall consist of a quetzal amount equivalent to one million U.S. dollars at the most favorable exchange rate used in Guatemala. The funds deposited into the Trust Account will be used to further the economic assistance programs in Guatemala, including administrative and operating costs of the USAID Mission present in Guatemala to carry out these programs. The USAID will be able to disburse funds deposited into the Trust Account for purposes deemed appropriate by the Director of the AID Mission, or by the Director's designee. USAID will disburse such funds in accordance with normal USAID disbursement procedures and practices and will provide a quarterly report to DFE as to the uses made of these funds.

ii. Counterpart Funding. While ongoing projects have already had P.L. 480 local currencies programmed for their FY 1986 counterpart funding needs, an additional amount from the local currency fund in the Bank of Guatemala may be set aside, as necessary, to assure that such projects have sufficient counterpart funds for FY 1986 and FY 1987. The Mission estimates that such funds could be required due to the high inflation which is expected to continue throughout 1986.

Also, the Mission is presently in the design stage of several projects which will probably require large amounts of local currency counterpart funding. For example, the Cooperative Strengthening Project (to start up in FY 1986) is presently analyzing different implementation alternatives. If the creation of a cooperative bank is recommended, approximately $10.0 million quetzales in local currency would be required for seed capital. Also, the Commercial Land Markets (1986) and Small and Medium Enterprise Development (1987) Projects will need fairly large amounts of local currency counterpart funds.

In addition, it is expected that counterpart funds will be required for other high priority projects of the GOG that are consistent with the USAID development strategy and which are financed by other international donors (e.g. the Interamerican Development Bank, the World Bank and the Central American Bank for Economic Integration). Illustrative uses of such projects are the IDB's Municipal Development Project (Q4.5 million), the Wholesale Market Centers Project (Q5.7 million), Urban Health Services (Q14.3 million), Secondary City Potable Water and Sanitation Project (Q5.0 million) and the World Bank Primary Education Project (Q5.8 million). Total GOG counterpart needs for these international donor ongoing projects for calendar years 1986 and 1987 are Q44 million. The need for GOG counterpart funding will undoubtedly increase as new project agreements are signed.

Other counterpart funding to be considered for use from the special fund in the Bank of Guatemala will be for Private Voluntary Organizations (PVOs). International and domestic PVOs have been very active in both development and disaster relief/reconstruction efforts in Guatemala. A portion of local currency funds under this program will be channelled to projects undertaken by PVOs.

iii. Special Development Projects

In addition to ongoing project counterpart funding, there is a need for local currency funding for activities which complement or otherwise assist the overall goals of both specific projects and the program in general. For example, in the area of education, local currency can be used to support activities related to ongoing projects, such as the following illustrative list:

- The Non-Formal Education project needs Q165,000 to fund counterpart costs for the construction of the radio station in Salamá. The pre-primary textbooks and teachers' guides developed by the Bilingual Education Project were printed in 1983 under Loan 029. Since that time, student enrollment has increased 50%. There is a need to reprint the above texts as well as supplementary materials for the new students who have enrolled since 1983. Funds estimated at Q400,000 are not available in the current project for this purpose.

- The Ministry of Education estimates that it needs funds for an additional 50,000 student desks for rural primary schools. The cost would be Q1,500,000.

- The 1,000 schools with bilingual promoters are in need of additional blackboards. AID will finance blackboards for 400 schools. The remaining 600 schools need blackboards at a total cost of Q210,000.

- USAID has a unique opportunity to expand rapidly the bilingual education program throughout the Highlands. This will require local currency funding to pay salaries for bilingual promoters and teachers. Top priority should be given to hiring bilingual promoters who serve as pre-primary instructors usually in schools which have only Ladino teachers. At present the Ministry of Education has on file requests from over 1,000 communities for a bilingual promoter. The cost for hiring 1,000 promoters for a year would be Q3,000,000. An agreement might be reached with the GOG to assume this annual salary cost.

Local currency can be used in other sectors as well. For example, there have been recent outbreaks of malaria in various parts of the country. Large sums of local currency could be used in the malaria campaign to hire more personnel, to pay for maintenance and repair of vehicles, to buy spray pumps, etc. Other illustrative uses for local currency projects are a Coffee Diversification Project with ANACAFE and a Reforestation/Forest Management Project with INAFOR. These types of projects could be 100 per cent local currency funded.

iv. Support of Private Sector Initiative. The Mission currently has identified other local currency uses in support of our private sector initiatives. For example, the HIG project currently under consideration that will be carried out largely through the private sector could benefit from local currency support. Such uses have already been discussed with

RHUDO. The Private Sector Coordination Project could also utilize local currency resources to assist the institutional development of the organized private sector in support of the newly elected goverment and to provide a mechanism whereby the public and private sector can dialogue over the need for constructive economic and social reform. Other possible uses of local currency generations in support of the private sector could be the creation of a joint venture fund which would be used to help attract foreign investment and a guarantee fund which could be used to ease the requirements of the banking community for inordinate amounts of collateral for loans. Such a guarantee fund could be used in support of the planned Cooperative Project and also the Small and Medium Size Business Development Project. In addition, the Mission is considering the need to use local currency generations to make available lines of credit for productive purposes and pre-export financing.

v. Local Currency Fund Administration

The Dirección de Financiamiento Externo (DFE) presently manages programs similar to the one proposed. In previous ESF programs which required the administrative assistance of the DFE, local currency funds were programmed to allow for such administrative costs. Although a large number of individual small projects is not expected, there is likely to be an additional administrative cost to the DFE associated with the management of this program. This is especially true with respect to project monitoring and auditing. Therefore, a small amount of funds under the program will be allocated to help the DFE defray this additional cost.

3. Exchange Rate for Conversion

The Mission anticipates as a condition precedent to disbursement of any ESF dollars that the Government of Guatemala will agree to set up appropriate counterpart accounts and to deposit local currencies therein at the highest rate of exchange which, at the time the deposit is made, is not unlawful in Guatemala.

7. Conditions and Covenants

The proposals contained in this PAAD have been discussed in general terms with the GOG. Working level contacts have been made with the Central Bank and the Ministry of Finance on the functioning of the local currency program and the proposed disbursement procedures for the loan. Now that the results of the recent elections are known and the new government has taken office and named its cabinet members, the Mission has begun discussions on these items.

The following are the conditions and covenants that the Mission proposes be attached to the $24.0 million cash transfer. Following Washington review and approval of these conditions, negotiations leading to a loan agreement with the GOG will be conducted. Any modifications to these conditions that may result from these negotiations will be communicated to Washington for approval prior to final authorization of the PAAD.

The Mission proposes the following conditions precedent to disbursement of the loan:

1. An opinion of counsel be provided acceptable to AID that the loan agreement has been duly authorized and/or ratified by and executed on behalf of the Government of Guatemala, and that it constitutes a valid and legally-binding obligation of the Government of Guatemala in accordance with all of its terms.

2. A written statement be provided of the name of the person holding or acting in the office of the representative of the Government of Guatemala under the loan, and of any additional representatives, together with a specimen signature of each authorized person specified in such statement.

3. The establishment of a quetzal fund in the Bank of Guatemala equivalent to U.S. $24,925,000 upon disbursement of the loan, to be used to finance development activities in Guatemala. The rate of exchange to be used in determining the dollar equivalent in quetzales will be the highest rate of exchange which, at the time the deposit is made, is not unlawful in Guatemala.

4. A written request for this assistance be sent to USAID stating the intention of the Guatemalan Government to undertake an economic stabilization program and outlining the content of such a program.

In addition to these conditions, the Mission proposes that the Loan Agreement include covenants relating to the implementation of the program as well as actions to be undertaken by the GOG to improve further the planning and implementation of development efforts and the Government's economic policies. These covenants are as follows:

1. To provide resources for the importation from the United States, within six months following disbursement of the loan, of $24.925,000 million worth of raw materials, intermediate goods and spare parts needed by private sector enterprises in Guatemala for continued production.

2. To undertake, jointly with AID, a review of the policies constraining economic growth and recovery and to implement appropriate fiscal and monetary policies designed to achieve economic stabilization. Such studies will be financed with $500,000 allocated under an ESF PD&S fund.

A. Assessment of Methods of Implementation and Financing

I.

Method of Implementation	Method of Financing	Approximate Amount
Cash Transfer - tranche releases upon evidence of progress in meeting adjustment program goals	Electronic Funds Transfers at AID/W level	$47,350,000

II. The Agreement to be signed with the GOG contains a covenant providing for an annual audit of financial and program activity, to be performed by an AID approved independent public accounting firm. The annual audit activity will be funded from the $23,425,000 equivalent matching local currency fund which will be established at the time of the initial cash transfer.

ANNEX I

GUATEMALA: PROSPECTS FOR ECONOMIC GROWTH AND DEVELOPMENT

Introduction

The Mission's ESF Policy Dialogue Plan identifies four areas of urgently needed economic policy reform: (1) fiscal revenue and the structure of public expenditures, (2) the exchange rate system, (3) pricing policies and (4) interest rates. This annex considers the policy recommendations given in the PAAD in greater detail within the context of the current state of crisis in the Guatemalan economy.

General Overview

As Guatemala returns to democratic rule, an unprecedented economic crisis threatens the social and political order. The external roots of the downturn are common to all countries of Central America: political instability, capital flight and worsening terms of trade. Flawed domestic policies in the early eighties of increased external borrowing, expanded fiscal deficits and the drawdown of Guatemala's once substantial international reserves served to eventually compound the problem, with today's results of negative real growth and a depreciated quetzal. Renewed economic prosperity in the future will come only with the adoption of a stabilization package which addresses the structural distortions which have built up in the Guatemalan economy in the past decade.

Recent trends in national output are summarized in Tables 1 and 2. In 1985, growth again turned negative, after a near standstill in 1984. The greatest setbacks, in percentage terms, occurred in the manufacturing sector, particularly in construction. Public and private sector investment, as measured in 1958 dollars, have fallen from 12% of GDP in 1978 to 5.5% estimated for 1985. Public sector austerity has been focused primarily on public investment, which in 1985 will achieve less than 40% of the level achieved in 1982.

Early Bank of Guatemala projections for 1986 show continued negative growth, in the absence of significant policy change. The estimated negative 1.5% growth for next year translates into an additional reduction of nearly five percent in per capita incomes, nearly the same as occurred in 1985.

External Sector

In the text of this document, the Mission extimate of Guatemala's balance of payments gap for 1986 totaled $392.3

TABLE 1

GUATEMALA: PRINCIPAL ECONOMIC INDICATORS

	1982	1983	1984	1985 1/
Annual Percentage Change				
Real GDP	-3.5	-2.7	0.8	-1.5
Real GDP Per Capita	-6.2	-5.3	-1.7	-4.2
Consumer Prices (CPI)	5.0	6.4	3.6	35.0 3/
Central Government Revenues	-1.5	-4.0	-5.4	22.8
Central Government Expend.	-17.2	-9.5	-0.4	1.2
Money and Quasi-Money	12.9	-0.4	18.1	20.5
Net Domestic Credit to Public Sector 2/	33.3	12.9	20.6 1/	N.A.
Net Domestic Credit to Private Sector	7.1	13.2	11.3 1/	N.A.
Merchandise Exports (FOB)	-13.2	3.6	3.7	-0.8
Merchandise Imports (FOB)	-17.1	-18.2	12.7	-7.0
Ratios to GDP (%)				
Exports (Goods & Services)	13.4	12.1	12.0	N.A.
Imports (Goods & Services)	15.9	12.6	13.5	N.A.
Current Account Balance of Payments	-4.6	-3.1	-4.0	N.A.
Central Gov. Revenues	8.4	7.8	7.1	6.7
Tax Revenues	7.2	6.1	5.3	5.2
Central Gov. Expenditures	13.1	11.5	10.9	8.5
Central Gov. Overall Surplus or Deficit	-4.7	-3.7	-3.8	-1.8 4/
Money and Quasi-Money (End of Year)	25.7	24.6	27.8	25.9

1/ Estimated.
2/ To Central Government.
3/ Higher level of inflation in 1985 is due to monetization from fiscal deficit, Central Bank losses of Q75-100 million, and higher import costs due to depreciation of the quetzal parallel rate.
4/ Anticipated to increase to 3-5% in 1986 as a result of inflation.

Sources: Bank of Guatemala and IMF.

5A

TABLE 2: Guatemala GDP by Sector of Origin and Expenditures

1982 - 1986
(In 1958 Q's Millions)

	1982	1983	1984	GOG 1985e	GOG 1986e
PRIMARY PRODUCTION	775.2	747.9	767.6	758.1	
Agriculture	765.4	737.1	759.8	751.4	N/A
Mining	9.8	10.8	7.8	6.7	
SECONDARY PRODUCTION	629.9	594.4	575.8	562.4	
Manufacturing	475.1	466.1	468.4	464.6	N/A
Construction	102.9	76.8	53.4	43.0	
Public Utilities	51.9	51.5	54.0	54.8	
SERVICES	1612.2	1594.0	1614.8	1600.3	
Transport	199.3	200.7	204.8	205.8	N/A
Commerce	793.0	762.8	770.5	749.7	
Finance	109.7	107.1	109.5	109.8	
Housing	145.4	149.2	151.9	154.9	
Public Admin./Def.	176.7	187.6	190.3	192.2	
Other	188.1	186.6	187.8	187.9	
GROSS DOMESTIC PRODUCT	3017.3	2936.3	2958.2	2920.8	2877.0
(Memo: Annual Real Growth Rate)	-3.5	-2.7	0.7	-1.3	-1.5
Plus: Imports of Goods and NSF	334.3	269.2	284.8	254.3	226.4
Less: Exports of Goods and NSF	510.2	454.7	449.7	454.5	453.6
DOMESTIC EXPENDITURE	2841.4	2750.8	2793.3	2720.6	2649.8
CONSUMPTION	2509.7	2480.5	2505.6	2475.3	2442.1
Private	2280.2	2247.7	2272.5	2250.8	2220.7
Public	229.5	232.8	233.1	224.5	221.4
INVESTMENT	355.8	259.4	229.9	221.4	227.7
Private	196.9	151.5	161.8	159.6	159.6
Public	158.9	107.9	68.1	61.8	68.1
STOCK ADJUSTMENT	-24.1	10.9	58.5	23.9	-20.0

Source: Banco de Guatemala

p = Preliminary
e = Estimated

Note: This table is based on the GOG's estimate of -1.5 percent real growth in 1986.

million, assuming a modest real growth level (1.5%) over 1985 1/ and continuation of the existing multiple exchange rate system. The other assumptions behind this estimate were detailed in the PAAD text.

The concept of a financing gap, it should be reminded here, is a variable, not a constant value and depends on the level of growth and other policy parameters. Mission estimates of the gap are based on a growth rate that is in the upper realm of the achievable for 1985, assuming coordination of donor support and ability to reschedule part of the onerous 1986 debt service. The gap estimate is understated in that it leaves out additior .l desired external support to build up net international reserves, which are currently at negative levels.

Balance of payments problems generally reflect policy weaknesses on the fiscal and monetary sides, which create an excessive demand for imports and which render foreign assets more attractive than their domestic alternatives. These kinds of problems, for Guatemala, are addressed in detail in the subsequent sections of this annex. External imbalance also arises when exchange rates are managed in such a way as to encourage imports and discourage exports, which is the present case for Guatemala. Hence, for Guatemala to be able, in the near future, to import at a level consistent with positive real per capita income growth, without recourse to extraordinary financing, from donors such as A.I.D., policy reform in exchange rate management is a sine qua non.

Prior to November of 1984, when the present multiple exchange rate system was established, Guatemalan policy makers dealt with foreign exchange shortages arising from the overvalued currency through rationing. This strategy led to the establishment of a currency black market and encouraged an increase in under and over-invoicing and nonrepatriation of export proceeds. The replacement of foreign exchange rationing with a multiple exchange rate system has created a new set of distortions, while hardly allieviating the previous ones. The following paragraphs briefly sketch the details of the complex multiple exchange rate system in operation today.

1/ With the GOG's assumption of -1.5% growth, the unfinanced gap is in the area of $160 million.

The new system provides for three legal exchange markets: the "official" market, where one quetzal can still buy one dollar, the "parallel" or "banking" market, where the rate is set with reference to supply and demand, and the "auction" market, of lesser importance, where foreign exchange is sold to the highest bidders among importers of certain designated commodities.

Among imports, only petroleum products, wheat, medicine, fertilizer and agricultural hand tools enjoy treatment under the official rate. Debt service also falls into this category. On the export side, most products are given only partial treatment at the parallel rate, with the percentage varying by product and by product destination, with regulations periodically changed by official decree.

A few examples will give the flavor of the system:

-- Exports of coffee to quota and nonquota markets convert, at existing prices, 100% of foreign exchange earnings at the official rate. Two months ago, (November 1985) 25% of quota and nonquota coffee earnings could be liquidated at the parallel rate. Four months ago, 100% of non-quota coffee and 0% of quota coffee proceeds could be converted at the parallel rate. The current arrangement expires in March of 1986, in the middle of the "coffee year" with, as yet, no indication of what the new policy will be.

-- Exports of manufactured items to Central American Countries yield 100% of export proceeds converted at the parallel rate. If the very same products are sold to the United States, the producer receives only 50% of his earnings at the parallel rate.

-- Among traditional agricultural products, cardamom receives 10 percent at the parallel rate; cotton, 50 percent; bananas, 0 percent; meat, 50 percent; nonquota sugar, 100 percent; and quota sugar, 0 percent.

In effect, the present system provides for a multitude of exchange rates, which are subject to frequent revision by the authorities. The complexity and arbitrariness of the system have created a still substantial black market, despite the supposedly "market-determined" rates in the banking market; a large incentive to cheat through under and over-invoicing, and substantial contraband, particularly for those commodities such as coffee which face the highest exchange penalties.

More importantly, the exchange system has engendered numerous distortions in resource allocation, and disincentives to production for export. The former is exemplified in the unrealistic pricing of petroleum-based products, such as diesel and electricity, which encourages overly energy-intensive production and consumption. The disincentives to export are not just inherent in the effective exchange rates received according to export commodity, but also in the administrative nuisance factors associated with the bureaucratic requirements of the system.

A further problem with Guatemala's foreign exchange system has not yet been mentioned. The supply of dollars to the official market is structurally less than the demand, leaving a shortage of the "one-to-one" dollars to pay debt service, import oil, and so on. The experience of 1985 shows the outcome of the official market deficit. In 1985, debt service payments were delayed and, equally important, production was disrupted as a result of the inability to pay for imports of petroleum and fertilizer. The Central Bank resorted at the end of the year to policies which encouraged accelerated sale of coffee and repatriation of coffee advance payments to "borrow" from 1986 to meet the 1985 official market gap. The _de facto_ movement, as of January 1, 1986, of all coffee proceeds back into the official market will sustantially narrow the official market gap, if coffee exporters can be persuaded to repatriate their dollars at the highly unfavorable official exchange rate.

The most immediate corrective measures to the problems cited below are elimination of the official market gap and the end to the arbitrariness and unpredictability of the exchange system. The Mission sees these short-term measures as logical steps toward the goal of unification. The desirable first commodity candidate for movement from the official into the parallel market is petroleum, since unrealistic petroleum product pricing is causing substantial distortion throughout the Guatemalan economy. Full unification, as soon as possible, however, should be an urgent concern of the newly elected regime.

Public Finance

The recent, severe problems associated with the exchange rate system have momentarily overshadowed Guatemala's fiscal imbalance, which has represented a weakness in the economy for many years. Guatemalan society has traditionally chosen a small public sector and conservative policies of fiscal management. This philosophy was consistent with the longstanding Guatemalan resistance to paying taxes, but in practice has been

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the proverbial sword which cuts in two directions. Conservative fiscal policy has left Guatemala without the staggering debt burden, the multitude of dubious public sector enterprises or the inflated public sector employment rolls that hinder development in many low-income countries. On the other hand, the lack of sufficient revenue to fund investments in human capital and physical infrastructure which are normally in the domain of the public sector has had a truly negative effect on Guatemalan development. Table 3 illustrates how Guatemala suffers low levels of achievement in health, sanitation and education despite its relatively high per capita income. This contradiction is largely explained by the continued lack of public sector programs and investment in support of development and greater equity.

The revenue insufficiency alluded to above is due to a sustained collapse of tax revenues over the past decade. This phenomenon has resulted from deteriorating tax administration, the inelasticity of the revenue structure and the inability to achieve sufficient political consensus to make tax reforms stick.

The following excerpts from a report prepared for the Mission on the Guatemalan tax system by Dr. Richard Bird describe the relative importance of the different problems the tax system exhibits:

> "The most important fiscal question facing Guatemala today thus concerns the causes of this unprecedented decline in revenues and, in particular, whether it can be expected to continue in the future. All the other possible, and valid, questions that may be asked about any revenue structure--its effects on resource allocation in the private sector, its impact on the distribution of income and wealth, and so on--are in a sense of secondary importance compared to the basic question of its adequacy to finance the minimal requirements of the public sector in a non-inflationary manner. On this test, it seems unlikely that the present tax system in Guatemala would pass muster, since it seems unlikely that any state with the slightest pretension to modernity can manage on revenues as minuscule as those currently raised in Guatemala."

> "Somewhat curiously, this most salient fact about the current situation does not appear to have achieved the attention it warrants, either within Guatemala or outside. Most Guatemalan discussion of taxation consists, as in

TABLE 3

REGIONAL COMPARISON

SELECTED DEVELOPMENT INDICATORS

	GUATEMALA	HAITI	HONDURAS	COSTA RICA	EL SALVADOR
Per capita Income (1983)	$1,120.00	$300.00	$670.00	$1,020.00	$710.00
Tax Revenues/GDP (1983)	0.063	0.127	0.120	0.155	0.112
HEALTH					
Population/Physician (1980)	8,610	8,200	3,120	1,460	3,220
% Population w/ Potable Water	49.8 (1980)	NA	55.0 (1980)	87.5 (1983)	53.2 (1982)
Child Mortality (Age 1-4) (1983)	5.0	15.0	8.0	1.0	6.0
Infant Mortality (1983)	67.0	107.0	81.0	20.0	70.0
EDUCATION					
% Primary Age Population Enrolled in Primary Schools (1982)	73.0	69.0	99.0	106.0	61.0
% Population Age 12-17 Enrolled in Secondary Schools (1982)	16.0	13.0	32.0	48.0	20.0
Literacy Rate (last census)	45.4	NA	59.5	89.8	59.7

Sources: World Bank - World Development Report 1985
SIECA - VII Compendio Estadistico Centroamericano 1983

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other countries, of complaints about high tax rates, inefficient administration, and undesirable economic incentives. All this may be true in some sense, but it is also becoming increasingly irrelevant in the face of the disappearing tax system. The marked decline in recent years has been matched by an equally marked decline in expenditures, and particularly in public investment spending, with the result that the deficit as a proportion of GDP has actually fallen from 7.0 percent in 1981 to only 3.1 percent in 1984. Perhaps for this reason even the international agencies seem to have missed the potential significance of the deterioration of the country's capacity to finance even minimal state activities."

This section of the annex will make the case that Guatemala's fiscal problems are atypical of the developing world. Hence the usual (and sound) recommendations made for most LDCs of cutting public spending, divesting parastatals and reducing tax disincentives to private sector initiative must be carefully qualified in the Guatemalan case. The goal of fiscal policy should be, for Guatemala, the retention of the positive aspects of its conservative fiscal management through continued expenditure discipline, combined with measures to promote economic development in a more focused way and to finance public expenditures without generating inflation.

a. Recent Trends in Central Government Expenditure

A 1978 World Bank publication noted that "by every indicator ..., the public sector of Guatemala is clearly among the smallest in Latin America."[1] Their conclusion was based on analysis of public sector revenues and expenditures back into the sixties. Table 4 and Chart 1 illustrate Guatemalan central government expenditures relative to GDP, separating current expenses from the investment budget. The most striking contrast to be noted in the table is between the relative stability of the operating budget and the volatility from one year to the next of investment expenditure.

Current expenditures of the Guatemalan central government vary between about 7 and 8 percent of GDP. This stability has implied for the recessionary years of the 1980s a decrease in real resources devoted to such expenditures. During this period, public sector salary increases have been few and of minimal magnitude. Low salaries have limited the public sector's ability to recruit and retain qualified personnel. The insufficient level of support funds (especially during the last

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TABLE 4

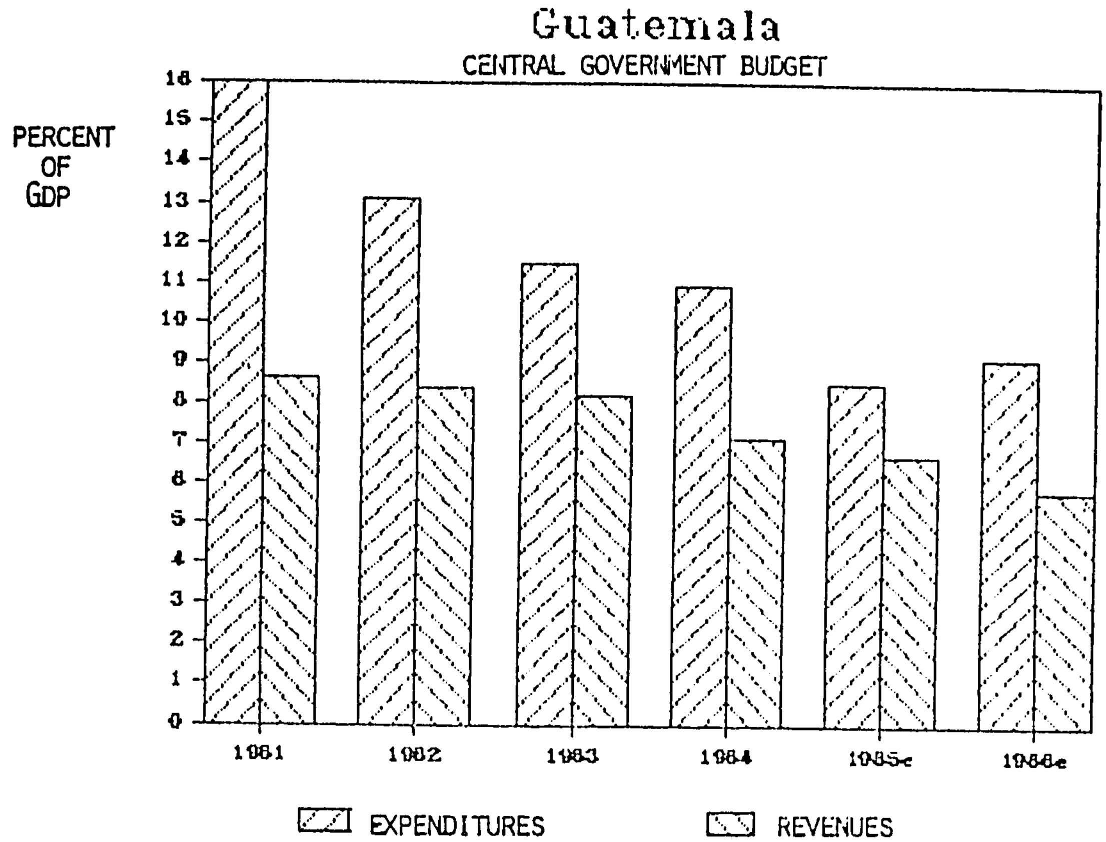
GUATEMALA:
Trends in Central Government Expenditure

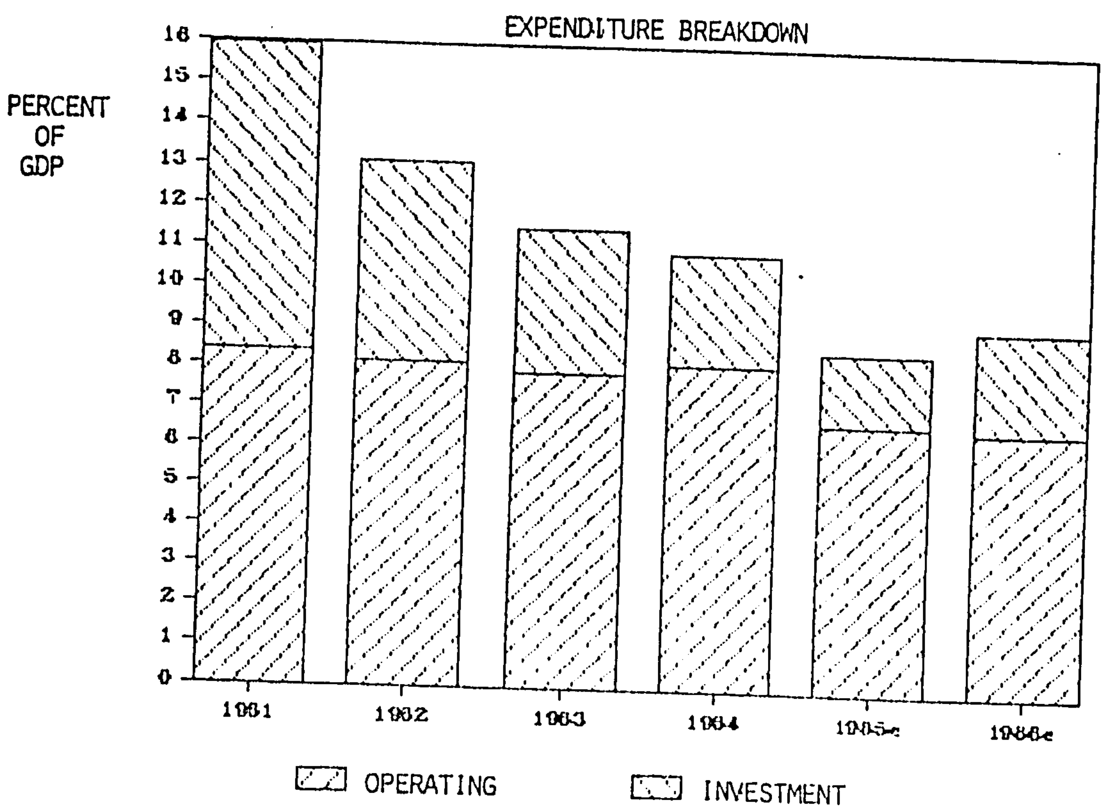
1973-1986
(Percentage of GDP)

	Current Expenditure	Capital Expenditure	Total
1973-1975 avg.	7.1	3.1	10.2
1976	7.6	5.9	13.5
1977	7.3	4.2	11.5
1978	7.7	3.7	11.4
1979	7.7	4.6	12.3
1980	8.3	5.9	14.2
1981	8.4	7.6	16.0
1982	8.1	5.0	13.1
1983	7.9	3.6	11.5
1984/p	8.1	2.8	10.9
1985/e	6.7	1.8	8.5

p/ Preliminary
e/ Estimate

CHART


Guatemala
CENTRAL GOVERNMENT BUDGET
PERCENT OF GDP
16
15
14
13
12
11
10
9
8
7
6
5
4
3
2
1
0
1981
1982
1983
1984
1985-e
1986-e
EXPENDITURES
REVENUES


EXPENDITURE BREAKDOWN
PERCENT OF GDP
16
15
14
13
12
11
10
9
8
7
6
5
4
3
2
1
0
1981
1982
1983
1984
1985-e
1986-e
OPERATING
INVESTMENT

two years), such as for per diem, gasoline and vehicle maintenance, has seriously hindered development efforts in the rural areas. As an example of the constraining effect of the decreased real levels of current expenditure, USAID/Guatemala's 1985 Education Sector Assessment points out that additional gains in primary education enrollment depend on the funding of more teacher positions. The allocation of additional funds to pay salaries for double shifts would then permit greater utilization of existing school facilities. The current negative trend in the level of revenues greatly reduces the likelihood of additional allocations for this purpose. In fact, this sector would do well if it were able to maintain existing funding levels in light of the above trend.

Capital expenditures as a proportion of GDP peaked in 1981 at 7.6 percent, a substantial increase over the traditional level of 3 - 4 percent. This acceleration of public sector investment was an expansionary policy response to the growing regional recession, and contributed to a large fiscal deficit and increased external borrowing. Unfortunately, much of the investment was in projects of low economic return, and the rapid increase in public construction works resulted in an inefficient application of resources. The country returned to a more conservative public investment program in 1983, partly to meet the IMF stand-by agreement requirements. Public expenditures in capital goods dropped back to 3.6 percent of GDP in 1983.

The persistent shrinking in tax revenues (discussed in more detail in the following section) has forced additional cutbacks in central government investment, to 2.4 percent of GDP in 1984 and 1.8 percent in 1985. These recent budget cuts have concentrated on school and hospital construction and road maintenance. Much of the ongoing investment in these development-oriented areas has been supported by USAID and other donor-funded projects. For Guatemala to achieve self-sustaining growth levels in the medium and long term, a greater national effort, with more emphasis on domestic resources, must be made in productive development investments.

b. Central Government Expenditure in 1986

Although a budget law has been published for 1986 by the outgoing government, revisions by the incoming leadership are likely. First, there is strong pressure for additional salary increases in the public sector, given current high rates of inflation and dissatisfaction with the Q.50.00 per month increase granted in September 1985. Second, if the new regime hopes to keep real capital expenditures constant, nominal expenditures would have to expand at the rate of inflation corresponding to investment inputs. This rate would be higher than the general inflation rate because many construction materials and equipment are imported. Third, the new constitution allocates more than 20% of current revenues to earmarks. The majority of the earmarked funds are for expenditures which do not currently come out of the national revenue "pie", most significantly the elimination of the local tax base with replacement through an 8 percent local government earmark. These constitutional revenue allocations will increase the rigidity of the national budget and will further restrict funds available for other uses. In addition, the new government has indicated plans to establish two additional ministries. While these new ministries would be merely shells within which existing government programs are to be housed, they may require some additional expenditure not reflected in the 1986 budget. Finally, if full unification is achieved, an increased level of resources will be needed to meet public external debt service payments, both of the central government and of the parastatals, as they will be valued at a rate higher than the present parity with the dollar.

All of the above factors imply that budgetary deficit pressures will worsen considerably in 1986. A realistic projection is there will be continuing temptation to economize on public investment and maintenance of existing public infrastructure. The role of USAID, through ESF conditionality and local currency allocation, in preserving Guatemala's development budget will be crucial as a counterweight to short-term budgetary pressures and competing demands for scarce public revenues.

c. <u>Recent Trends in Central Government Revenues</u>

Guatemala has suffered a serious fiscal imbalance throughout the eighties. In the early part of the decade, the rapid increase in public sector spending without corresponding revenue measures caused the widening of the fiscal deficit to a peak of 7.2 percent of GDP in 1981. Thereafter, reductions in the deficit to 3.4 percent of GDP by 1983 were accomplished though spending cuts. The focus on expenditure reduction as a means to deal with the budget deficit has deflected attention from the progressive collapse of revenues, particularly from taxes. Chief among Guatemalan tax system flaws are its high inelasticity, excessive dependence on indirect taxes and deteriorating administration. The tax system is described in substantial detail in two 1985 cables, GUATEMALA 7250 and GUATEMALA

9188. A summary of current issues and problems is presented in this section.

Table 5 shows recent revenue levels by major category of tax. Most striking are both the heavy reliance on indirect taxes and the persistent deterioration each year of tax revenues relative to GDP. In fact, this contraction of tax effort has occurred nearly every year since 1978, when it peaked at about 10.3 percent of GDP. The nominal increase in tax collections noted in 1985, and projected for 1986, reflect response of some taxes to inflation, particularly the value-added tax.

What has caused the progressive deterioration of the Guatemalan tax effort? A list of the most important factors would include the lack of response of most taxes both to inflation and to the depreciation of the quetzal, the legacy of the 1983 tax reform, and serious and worsening problems in tax administration. The new government will be forced to deal with these tax system flaws, particularly if it intends to reduce the inflationary pressures of a growing budget deficit, projected at more than Q500 million for 1986.

The first explanatory factor of the dropoff in tax effort, the general inelasticity of the tax system, will become increasingly problematic as inflation accelerates. The revenue elasticity of the Guatemalan tax system was estimated to be .747, which means that if GDP grows by 10%, tax revenues grow by only 7.47%. Hence, tax revenues have not achieved increases in proportion to inflation and to the devaluation of the quetzal. This has created a tendency for a growing public sector deficit, since government expenditures rise with the general increase in the price level. For example, until January 1986 when Rule 3 was imposed, the import duties were charged according to the quetzal value of the import, valued at the official (Q1.00 per U.S.$1.00) exchange rate. Therefore, despite the increase in the quetzal value of imports with the introduction of the parallel market, import tax revenues did not rise in 1985 as a result of this method of valuation. However, for income tax purposes, imports which are business expenses were deductible at the exchange rate paid, which tended to reduce income tax collections, all else equal. To cite another example, property values are rising with inflation, but until there is a reassessment, property tax revenues will not grow accordingly.

Another area of weakness is in tax administration, which stems from technical incapability, lack of political will

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TABLE 5

GUATEMALA:
Financial Operations of the Central Government

1983-1986
(Q's Millions)

	1983	1984p	1985e	1986e
MEMO ITEM				
CPI % Increase	6.4	3.6	35.0	40.0
REVENUES	742.9	668.9	821.0	977.0
Tax Revenues				
Import	65.8	78.6	81.0	87.6
Value-Added	44.5	142.5	203.7	230.7
Stamp	181.8	32.4	50.0	57.0
Liquor/Cigarettes	58.1	63.8	75.5	76.4
Petroleum Prod.	24.5	43.9	42.0	45.0
Income	128.2	78.5	103.8	109.2
Vehicle	9.1	9.2	10.0	10.9
Property	5.4	5.9	14.0	18.7
Exports	39.8	28.4	8.1	0.0
Fx Transaction	0.0	0.0	30.0	99.7
Compensation Fund	40.7	31.4	69.5	n.a.
Other a/	145.0	154.3	133.4	241.8 /b
EXPENDITURES	1038.1	1029.7	1042.4	1533.6
Operating	721.2	766.5	824.3	1110.3
Investment	316.9	263.2	218.1	423.3
DEFICIT	-295.2	-360.8	-221.4	-556.6
Internal Financing (Net)	214.8	337.9	206.6	412.9
External Financing (Net)	80.4	22.9	14.8	143.7
Taxes/GDP	6.3	5.3	5.2	4.6
Revenues/GDP	8.2	7.1	6.7	5.8
Investment/GDP	3.5	2.8	1.8	2.5

a/ Includes capital revenues and other current revenues
b/ Includes revenues for petroleum compensation fund.
p/ Preliminary
e/ Estimate

Source: Bank of Guatemala

and the insufficient level of human and physical resources devoted to the task. Many of the taxes are not computerized, or the computers are not operated to reach maximum efficiency. Tax registries are out of date and incomplete. The Ministry of Finance is demoralized, especially given recent widely reported discoveries of fraud and mismanagement. This problem will require, first of all, a determination by the new government to turn around the Finance Ministry and give priority to proper administration of the existing tax system.

The third oft-cited source of problem in Guatemala's tax system can be traced back to the 1960s. Guatemalan society has had a traditional resistance to tax measures, which has always made tax reform a politically sensitive area. Looking back to the 1983 IMF-supported tax reform is one recent example. The tax system changes put into effect at that time were well-formulated solutions to the traditional deficiencies of Guatemala's tax system. However, substantial protest occurred as a result of the introduction of the value-added tax which was partly responsible for the coup removing Chief of State Ríos Montt from office. There is normally strong public protest of any new tax measure, and there has been an increasing inability of the Guatemalan leadership to make tax reforms stick. This trend was observed again when then Chief of State Mejía Víctores reduced the VAT percentage from 10 to 7 in 1983. Once more, in early 1985, an attempt at a new tax package was short-lived, as public pressures caused the Chief of State to rescind the April fiscal package after only a few days. The outgoing leadership did not impose Rule 3 and a set of new selective consumption taxes until their very last days in power. Even with a strong political mandate, the history of successful popular rejection of any attempt to improve the tax system portends that the incoming government will find it a political challenge to make the new taxes stick and to enact any substantial changes. However, President Cerezo has publicly indicated that fiscal reform will be a major concern of his administration, particularly in shifting the emphasis of the tax structure toward a greater reliance on direct taxes. The position which the organized private sector takes either in support of or against fiscal reform will be an important determinant of the Cerezo administration's ability to successfully deal with the fiscal deficit.

d. Central Government Revenues in 1986

If the new government makes no additional changes in the tax system, what can it expect during its first year in office? First, as noted earlier, continued inflation will mean

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that existing revenues, although growing somewhat in nominal terms, will buy far less by way of usual expenses of government. In addition, the new Constitution provides several changes in the way taxation is controlled within Guatemala. The Constitution vests all power to tax solely within the Congress. This means that local governments will no longer have the right to raise taxes. Also, all new tax legislation must be approved by the Congress.

An additional revenue shortfall may result from the issuance of CATS tax-rebate certificates (which are fiscal incentives for nontraditional exporters). A substantial number of applications for these certificates, which can be used to pay income taxes, have been received. The effect of these certificates on 1986 tax collections has not been calculated by the Central Government, but is expected to be significant.

The conclusion is that the new civilian government will have to move quickly to address the problems inherent in the tax system, and do so in such a way that avoids the confrontations, expecially with the organized private sector, engendered by tax reforms in the past. To do otherwise will leave Guatemala with a fiscal deficit 250% or more larger in magnitude than that which prevailed in 1985.

e. Recent Trends in the Rest of the Nonfinancial Public Sector

The rest of the nonfinancial public sector comprises the Social Security Institute (IGSS), the municipalities and the nonfinancial public enterprises (parastatals). The IGSS, which relies on the Central Government for part of its revenue, has generally shown a small surplus in recent years. The municipalities depend in part on local revenues and in part on transfers from the Central Government, particularly for investment expenditures. For example, the largest municipality, Guatemala City, receives much of its income from local property taxes.

Compared to other developing countries, Guatemala's public enterprises account for a relatively small portion of national output and only about 20% of the total nonfinancial public sector. The major parastatals are the electric company INDE and the phone company GUATEL. INDE has run a deficit in recent years, mainly due to Chixoy cost overruns. If INDE's purchases of petroleum products and debt service payments were priced at their true economic cost, however, their deficit problem would be even more severe given current tariffs for electricity. (This problem will be partially mitigated as Chixoy comes more fully on line.) GUATEL has shown a small surplus in recent years, part of which is transferable by law to the Central Government. However, as with INDE, their financial picture would deteriorate if their external debt had to be paid back at a more market-oriented exchange rate. 1986 debt service requirements for both INDE and GUATEL are shown in Table 5 of the PAAD.

The other parastatals are small and in general pay their own way. The eleven public enterprises include two port authorities, the Guatemalan airline, a milk processing plant, the Guatemalan railroad, and the merchant marine. The ports have abnormally high user fees and a portion of their income is turned over to the Central Government. Private sector groups would like to see a reduction in port charges as a small incentive to increase exports. Any such reduction, however, would further increase the fiscal deficit.

The popular perception is that the public sector firms are large drains on the economy. (The merchant marine is frequently cited by the private sector because it has no ships. Allegedly, however, it was less financially healthy when it <u>had</u> ships.) In fact, as a group, with the exception of INDE, <u>they</u> have represented no significant burden. Even the IMF has not targetted Guatemala's nonfinancial public enterprises as major areas for policy reform. The major issue for policy reform relating to the nonfinancial public enterprises in the foreseeable future will be the tariffs charged by INDE and GUATEL, which will need to be adjusted in line with the depreciation of the quetzal.

<u>Wages and Prices</u>

1985 will be remembered as the year inflation first got out of hand in Guatemala. Traditional levels of increase in the price level have been low, and due primarily to the same forces which drive world inflation. In the past year, new elements have been introduced which have fueled inflation, contributing to a December 1984 to December 1985 increase in the consumer price index preliminarily estimated at about 35%. At blame for the present inflation are the increased cost of imported goods resulting from the depreciation of the quetzal in the parallel market (termed "corrective inflation"), and monetary expansion due both to the fiscal deficit and Central Bank losses on exchange transactions. Table 6 shows the trend in the CPI for Guatemala City, the most up to date data available.

16-Dec-85

TABLE 6

CONSUMER PRICE INDEX

Guatemala City
(March - April 1983 = 100)

		INDEX	PERCENTAGE INCREASE
1984	October	109.7	
	November	113.2	3.2%
	December	114.6	1.2%
1985	January	114.0	-0.5%
	February	114.0	0.0%
	March	113.9	-0.1%
	April	115.8	1.7%
	May	120.2	3.8%
	June	124.0	3.2%
	July	130.9	5.6%
	August	137.4	5.0%
	September	135.9	-1.1% 1/
	October	141.9	4.4% 1/
	November (1st Week)	148.5	4.7% 1/
December 1984 - November 1985 (1st week)			29.6%

1/ CIE, Correo Economico, 11-28-85

Source: Instituto Nacional de Estadisticas
Seccion de Precios

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Adjustment to persistent price increases is starting to occur, with entrepreneurs and consumers learning to operate within the new environment. This prompted accusations of gouging and goods speculation against the commercial sector, culminating in the placing of some 450 individual product items under price controls (retail and wholesale) in September of 1985. Many of the products have since begun to disappear from the shelves, as producers' costs become higher than the legal wholesale limit. Many marginal producers, faced with negative profits, increasing costs and pressure for wage increases, have or may have to shut down operations. In the absence of the cap on prices, producers would be better able to adjust to the rapidly changing environment.

The prognosis for inflation in 1986 is not optimistic, particularly in the absence of a stabilization program. The fiscal deficit combined with continuing exchange losses of the Central Bank could surpass Q1000 million, most of which would be translated into a money supply increase. In the absence of an interest rate policy which encourages savings, this problem will be exacerbated. The Bank of Guatemala projection of roughly 40 percent inflation again in 1986 has the potential to be a vast underestimate. On the other hand, a stabilization program which maintains moderate growth of credit, eliminates excessive monetary expansion through exchange rate unification, and reduction in the fiscal deficit, and allows for market-oriented interest rates could convert current inflation trends into a temporary phenomenon.

One important determinant of the magnitude of the deficit in 1986 will be the government's pricing policy for petroleum products and electricity. The discontinuance of the current petroleum subsidies, and the movement of product price to more realistic levels which reflect their true opportunity costs, would assist in a sorely needed stabilization within the economy. On August 1, 1985 the Government of Guatemala took some action in this direction when it increased the price of gasoline per gallon to approximately 3 quetzals from the previous level of about 2 quetzals, or about a 50% increase. Further increases will probably be needed, especially if the quetzal returns to its former rate of Q 3.80 to U.S. $1. In addition, by removing petroleum from the list of 'essential' imports, which are paid for at the official rate of Q 1 = U.S. $1, the Government should be able to reduce the trade deficit. A more realistic pricing of electricity is also needed, one which reflects the relatively high cost of production which exists in Guatemala.

One issue under discussion is the effect exchange rate unification will have on the price level, particularly for the low-income consumer basket of commodities. Former Central Bank President Oscar Alvarez carried out an analysis of this issue as part of the formulation of the September 1985 policy package, which was never adopted. He found that at a unified rate of Q.3.00 per U.S.$1.00, the price of basic consumer basket would rise by only 16%, with nearly the entire increase due to higher fuel costs. For higher-income consumers whose purchases have a greater import component, this increase would be somewhat larger.

On the wage side, payments to labor have been generally stable over the past five years, owing in part to high unemployment and depressed demand. In the public sector there had, until this year, been virtually no salary increases over the past decade. The minimum wage has not been changed since 1980. However, the burgeoning inflation has heightened pressures within both the private and public sectors to raise salaries, as standards of living fall. The Chief of State decreed a Q50.00 per month increase in salaries for most public employees in September of 1985. However, since this measure will add some Q100 million to the fiscal deficit on an annual basis, it implies an additional spiraling of inflation. There has been no publicly mandated increased in private sector wages, but a recent survey of the CACIF membership reported that 92% of respondents had given cost-of-living increases in the past year. Of those giving increases, the median was 11-15%, as described in Table 7.

Interest Rates

Of the policy issues addressed in this annex, the interest rate question is the most straightforward and requires the least exposition. Commercial bank interest rates are subject to a ceiling of 12% for borrowers and 9% for savers. These rates are highly negative in real terms given inflationary trends. The distortions resulting from current interest rate policies are many: credit is allocated for projects that do not have the highest productive potential (e.g. much short-term credit has gone for purchase of dollars by speculators), savers have been encouraged to convert quetzals into holdings of dollars and physical assets rather than maintaining bank savings accounts, and bank holdings of quetzales have been diminished and volatile, based mostly on demand deposit account balances. In sum, the symptoms of Guatemala's interest rate ceilings are typical of countries which practice financially repressive policies.

29-Dec-85

TABLE 7

REPORTED SALARY INCREASES

Guatemala - 1985

Public Sector	:	Q50 per month, except for highest paid public employees	
Private Sector 1/	:	No salary increase	8.05%
		Less than 10%	5.17%
(35% response to CACIF survey of its membership, reported in "El Industrial")		11-15%	41.38%
		16-20%	32.18%
		21-25%	5.75%
		More than 25%	7.47%
			100.00%
Minimum Wage	:	No change	

1/ Since survey results are based on voluntary response by CACIF membership, they may be biased by a higher response rate from firms which have given increases.

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The elevation of interest rates to positive real levels is crucial to alleviate the speculative demand for dollars and to generate a domestic source of loanable funds which will reduce the dependence on external borrowing. A positive interest rate for savers will counter inflationary tendencies by withdrawing liquidity from the economy, instead of having those same quetzals chasing after the limited supply of goods. Thus, the Mission sees interest rate reform as critical to a stabilization program. Ideally, interest rates should not only be raised, but a mechanism providing for greater flexibility in response to price level changes should be implemented.

ANNEX II

CHRONOLOGY OF GUATEMALAN EFFORTS TO IMPLEMENT A STABILIZATION PROGRAM IN 1985

As the Guatemalan economic crisis deepened in 1985, a number of attempts were made to design and impose an economic program to forestall the deterioration of the economy. None of the efforts succeeded, in part because of an inability to reach the internal political consensus required to take definitive action. This section details the chronology of these efforts over the past year. The purpose of this description is to detail the political interplay among the various sectors of the economy in reaching consensus on economic matters. This chronology will preview potential political frictions the Cerezo government may face as it enacts its economic program this year. It also highlights some of the ways in which consensus can be reached within Guatemalan society.

The past year's events may be roughly divided into 1) the first IMF visit and the "April Reform Package," 2) the "Grand National Dialogue Package," 3) the September 10 Proposal to the Chief of State and the second IMF visit, and 4) the "Holding Package."

1. The First IMF Visit and the "April Reform Package"

Guatemala had signed a $120 million stand-by agreement with the IMF in 1983. Disbursements were suspended in mid-1984, (with some $60 million remaining) as a result of Guatemala's falling out of compliance with the terms of the adjustment program, particularly targets for revenue generation and liberalization of the foreign exchange rationing system. By the end of the year, Guatemala had slipped even further off of its program goals, with domestic credit creation reaching a rate well above the target and a more than doubling of external payments arrears, from $220 million to $490 million.

An IMF team visited Guatemala in March of 1985, for their regularly scheduled Article IV consultation. At that time, there was interest on the part of the Guatemalan Government in arranging for a new stand-by agreement, which they hoped would have disbursed approximately $60 million in 1985 (judging from their inclusion of this figure in early 1985 balance-of-payments projections). Several weeks after the IMF visit, the Chief of State announced a comprehensive fiscal reform package, presumably in response to IMF recommendations.

The April package, which was implemented by a surprise executive decree, included the following measures: a set of selective consumption taxes, a change in the valuation method of imports for calculation of duties, a reduction in the number of commodities exempt from the value-added tax, export taxes for a number of traditional export commodities, more favorable exchange treatment for cotton and quota coffee, an increase in interest rates, an increase in reserve requirements and limits on domestic credit expansion.

Since there was a measure in the package to enrage practically every sector of Guatemalan society, protest was immediate and widespread. The private sector was particularly vehement about the tax increases, which they saw as an attempt to increase the role of the public sector in the economy. The opposition nearly brought down the Mejia Victores government, and the end result was that the package was rescinded only a few days after it was announced. The IMF subsequently judged that the inadequacy of current policies to deal with imbalances in the economy made a new stand-by agreement inadvisable in the near term.

2. The National Dialogue

After the debacle of the April Package, Chief of State Mejia Victores turned to the Guatemalan people for guidance in developing a set of economic measures that would be acceptable. The forum he established became known as the "Grand National Dialogue." In practice, this was an economic working group composed of leaders from the both the public and business sectors, as well as from segments of the economy that had not been given a voice in national policymaking in the past. These latter groups included cooperatives, labor unions and the universities.

The Dialogue met regularly over several months. The early meetings mainly represented an education process, as the public sector representatives presented information on the precise nature of the economic problems Guatemala was experiencing. This aspect was important, because the private sector had viewed the April fiscal package as a unilateral attempt by the Chief of State to enlarge the size of the public sector, a trend they unanimously opposed. The later meetings of the Dialogue focused on identification of measures to deal with these problems. On July 1, 1985, an economic policy package agreed upon within the working group was put into effect.

The National Dialogue package was very much a compromise set of reforms. The public sector agreed to cut spending by an additional Q.72 million through the end of 1985. The private sector agreed to several new revenue measures, including a foreign exchange transactions tax, selective consumption taxes not to exceed Q.10 million, and an increase in the airport departure tax. These measures were expected to yield an additional Q.72 million in revenue in the last six months of 1985 (Note: the decree imposing these selective consumption taxes was not announced until early January of 1986, and the yield of the foreign exchange transactions tax has been far below the initial projection). On the exchange side, a number of import commodities was removed from the essentials list, amounting to roughly 15 percent of the value of all commodities receiving exchange treatment at the official rate. The private sector received agreement from the government that several important issues would be studied, including the implemention of an open seas and skies policy and the reduction in export red tape. Labor received a commitment from the private sector that salary increases in response to the rising inflation would be encouraged, "according to each firm's possibilities."

The leadership of the National Dialogue subsequently travelled to Washington, and met with both U.S. government officials and representatives of the multilateral donors. They requested an IMF visit for the second semester of 1985, and emphasized the willingness of the different sectors of the Guatemalan economy to work together to solve Guatemala's economic crisis.

The importance of the Grand National Dialogue process as a watershed in Guatemalan history cannot be underemphasized. Groups in society which a few short years ago were suffering overt persecution were invited by former Chief of State Mejía Víctores to participate in formulating national policy. More importantly, the Dialogue demonstrated that there <u>is</u> capacity for compromise in Guatemala. Within the process, the private sector agreed to higher taxes, the public sector agreed to cut spending, and organized labor agreed to a process for mediating wage demands. When the package was announced, it was accepted without complaint by any sector.

3. The September 10 Proposal and the Second IMF Visit

Two additional economic measures were taken after the Dialogue package was imposed. In early August, gasoline prices were raised by about 50 percent. This measure was taken to counteract the exchange losses the Central Bank was incurring due to the structural deficit in the official exchange market, within which the largest import category is petroleum products. The public was well-prepared for the price increases, since there had been substantial publicity about the lack of dollars to meet oil bills and the need to sell gold ("the national patrimony") to generate foreign exchange. In addition, the public had already experienced spot shortages of petroleum products.

In late August, in response to complaints from the transport sector that existing tariffs forced private sector bus owners to run a loss, the Chief of State decreed a 5 centavo intraurban bus fare increase, raising fares from 10 to 15 centavos for the large diesel-fueled buses, and from 15 to 20 centavos for the smaller gasoline-powered minibuses. This measure was taken after some transport owners had unofficially started charging higher fares to their customers.

Within the Central Bank and Ministry of Finance, meanwhile, had grown the perception that the National Dialogue, while a laudable effort, in substance was too little and too late to stem the downturn which was growing visibly worse. Also, these officials were aware that the measures taken thus far would not be enough to achieve a new IMF stand-by agreement, the hoped-for outcome of a second IMF visit scheduled for September. For these reasons, a stabilization package was prepared within the Bank of Guatemala, with support of the Ministry of Finance, and discussed by the Junta Monetaria in August and early September. The intent was to review the proposed measures with the IMF, with possible implementation after the elections but before the new government took office. The plan reportedly included policy changes such as unification of the exchange rate, an increase in interest rates and new export taxes.

Despite the well-laid plans, the effort fell apart. The Chief of State rejected the Junta Monetaria's proposal for exchange rate unification. The mid-September IMF visit coincided with public disturbances over the bus fare increase. At the same time, there were strikes in the Central Bank and Ministry of Finance which impeded the IMF team's work. The end result was that hopes for adoption of a stabilization program, and for an early rapprochement with the IMF were virtually eliminated for the rest of the 1985. In addition, the President and the General Manager of the Central Bank resigned, as did the Minister of Finance.

d. The "Holding Package"

September's public protests over the bus fare increase and the rising price level, and the spreading of strikes within the public sector were causes for concern within the Guatemalan government, as it raised the fear that the disorder might eventually endanger the electoral process. In mid-September, to appease the public discontent, a "holding package" was put together, whose stated purpose was to "hold" the country together through the end of the year.

The new set of policies comprised the following: (1) the bus fare increase was rescinded; (2) an urban transport subsidy was established which amounts to roughly Q.2 million per month; (3) public employees were granted a salary increase of Q.50 per month, which raised the government wage bill by more than Q.100 million on an annual basis; (4) wholesale and consumer prices on 40 products were rolled back to the June-July level and frozen; (5) the exchange houses were closed; and, (6) a criminal penalty was established for dealing in foreign exchange outside of the banking system.

The most significant aspect of the "holding package" was that it more than reversed the positive gains of the National Dialogue process, particularly in terms of the fiscal deficit. The measures represent a definite step backwards in progress towards an IMF agreement. However, the package had its desired short-term effect -- the public was appeased, and the strikes and public protests shortly died down.

e. Economic Reform Prior to the Inauguration of the New Government

When the "holding package" was announced, the Chief of State also promised that this would be the last set of economic measures his government would undertake. All further economic reform would be left to the new government. Fortunately, there was a change of heart and several important measures were implemented in early January 1986. Rule 3, a change in the way imports are valued for duty purposes, was imposed with the adoption of the new Central American Common External Tariff. Depending on the level of the parallel rate in 1986, Rule 3 could more than double import tax revenues. Selective consumption taxes on luxury goods had been agreed to within the National Dialogue, but were delayed in implementation because of disagreements over which commodities would be taxed. In its final days, the outgoing government passed a decree establishing these taxes, with the specific items to be determined through administrative action. This means that the new government can impose this set of taxes without going through the Congress. Early implementation of these two measures was beneficial in limiting the political cost to the incoming government.

f. Conclusions

What does the above chronology tell us about the prospects for implementation of a stabilization package in early 1986, and more importantly, its acceptance by the public? Will the private sector oppose all efforts at fiscal reform? Will the public react in a strongly negative way to a year of austerity in 1986?

The Mission's projection about the degree of acceptance of a stabilization program in the coming year can be termed "cautiously optimistic." The account presented above illustrates clearly the conditions under which policy changes can be successfully enacted, and the kinds of actions which nearly guarantee their defeat. First, the new government is at a considerable advantage over its predecessor in that it has greater legitimacy, in having gained office through the votes of a strong plurality and in a clean, fair election. Many in the private sector saw the arbitrary rule of the previous administration, where economic policy changes occurred overnight by decree, as only reversible through strong reaction after the fact. The establishment of a democratic system, in which economic policies will be formulated by an elected leadership, provides in their view a greater potential for constructive participation in the early stages of the process, rather than recourse only to a harsh and abrupt veto at the very end.

The second lesson is related to the first. The National Dialogue Process showed a much greater willingness for compromise on economic issues among the various sectors of Guatemalan society than most people would have predicted. If the new government draws on the philosophy of multisectoral discussion in formulating its economic program, it will reduce the likelihood of public rejection of the policy changes which result. The organized private sector has already met with the new government and has expressed the desire to work with it in formulating economic policy.

Finally, the events in 1985 showed the importance of public education about the nature of the economic problems and the required solutions. A private sector spokesman criticized the way in which the April Package was announced, saying that the Government of Guatemala had not informed the public about the seriousness of the problems the country was starting to experience. When the package was put into effect to deal with the crisis, the common response was "what crisis?". The lack of prior preparation of the public left them off-guard and suspicious of the new tax measures, with the mistaken perception that the Chief of State had a secret plan to increase the size of government (rather than cure the growing fiscal imbalance). The key difference between the economic measures which were accepted and those which were not was the degree to which a successful education effort had been mounted.

ANNEX III

GUATEMALAN TRADE AND PAYMENTS WITHIN THE CENTRAL AMERICAN COMMON MARKET (CACM)

Introduction

Among Guatemala's economic woes in 1985 were the continued deterioration of Central American trade and the continuation of the trade payments difficulties among the country's regional partners. Since Guatemala's light manufacturing base was formed in response to regional market opportunities, the disintegration of this market has strongly contributed to continuing rates of low or negative real growth. This section reviews Guatemala's position and prospects as part of the Central American regional market.

The formation of the Central American Common Market (CACM) in 1961 brought increased cooperation among the member countries of Guatemala, Costa Rica, El Salvador, Honduras, and Nicaragua. The original entity included a payments clearing house, a development bank, a common regime on investment incentives, a secretariat, and an industrial complementation program. Throughout the 1960s and 1970s, the CACM facilitated trade within the region which encouraged the development of a light industry manufacturing base centered on import-substitution and increased agricultural production. During this period, the CACM played an especially important role in Guatemala's economy in providing a market for manufacturing such products as textiles, clothing and chemicals and agricultural produce. In fact, during the 1965-1980 period products sold to the CACM member countries accounted for 32 percent of all Guatemalan exports. Guatemalan products made up an average of 31 percent of all exports within the CACM during the same period.

The beginnings of dissention within the CACM can be traced to Honduras' withdrawal from the Market due to the 'Soccer War' of 1968-69 between that country and El Salvador. Aside from that incident, the CACM functioned relatively smoothly until the late 1970's when external and internal influences began to impede its operation. External factors included the recession in the industrialized countries which reduced the demand for the region's exports, the decline in world prices for many of the commodity exports upon which member countries were, and are, very reliant, and the second oil price shock. Internal factors included political turmoil within the region, a decline in cooperation among the countries, and inappropriate or ill-timed government policy responses to outside forces. In addition, many of the CACM countries maintained fixed exchange rates and did not allow them to adjust to changes in the marketplace. This resulted in a misalignment of rates vis a vis other countries within the region and in other areas of the world. The co...ination of the above factors had a debilitating effect on the economic health of the region, as demonstrated by the substantial decline in real per capita income. Regional real per capita income in 1984 was equivalent to that of 15 years ago, which means that 11 years of economic growth have been neutralized by the economic downturn which has been ongoing since 1980.

Current Trends

The period encompassing 1980 to the present has been particularly harmful to the regional economy. One example of this has been the trend toward decreased intraregional trade. For instance, Guatemala's exports to other CACM countries fell 34 percent, and imports from them declined 14 percent from 1980 to 1984. While it should be noted that 1980 was an abnormally good year for trade and thus a slightly unrealistic benchmark figure to use, the overall trend has still been negative. Contributing to the reduction in trade are mounting intraregional trade debt, scarcity of foreign exchange, reduced levels of real per capital income, and misalignea exchange rates.

The extent of intraregional debt is currently one of the largest impediments to trade. As of November, 1985, Guatemala was owed approximately U.S. $235 million by the member countries and was indebted to Costa Rica for U.S. $70 million. The net figure of U.S. $165 million accounts for much of Guatemala's international reserves. Nicaragua and El Salvador are the principal debtors. Both are heavy importers (imports were especially high in 1980 and 1981) but have been unable to generate sufficient earnings to settle their trade accounts. Because the level of indebtedness has persisted, the surplus countries, Costa Rica and Guatemala, have taken measures to at least check the current upward trend in debt. Costa Rica announced earlier this year that it would only export items to Nicaragua and Guatemala if they received imports of equal value, in effect a barter transaction. Guatemala has reached an agreement with El Salvador to accept bunker fuel oil in lieu of currency to help offset the existing trade debt. Members have also been making separate trade agreements with countries outside of the CACM such as Mexico, Venezuela and Columbia in an effort to open markets for their exports which will generate dependable sources of foreign exchange.

Another trend has been the declining use of the CACM's Central American Clearing House (CACH) as a means of processing intraregional trade payments. The system was set up so that the member countries' central banks could process the trade-related monetary transactions. Accounts were to be settled every six months and the outstanding debt was then to be paid in U.S. dollars. Because of the inability of some countries to meet their obligations, much of their debt in the CACH has been converted into long-term debt. The level of Guatemala's transactions financed through the CACH declined about 21 percent from 1980 to 1984. It is estimated that the CACH, once used for the majority of intraregional trade transactions, now accounts for only about one-half all such transactions. Underground trade between countries has increased as exporters have become increasingly reluctant to go through official channels, either because of difficulties in obtaining export or import licenses or because of unfavorable conditions relating to the surrender of the resulting proceeds.

Misalignment in regional exchange rates is another distortion that has developed over the period. Many of the member countries had, until recently, pegged their currencies to the dollar, and had allowed these fixed exchange rates to become progressively overvalued. This meant that in many instances they were misaligned with respect to other CACM countries. As a consequence, trade patterns developed which were a cause for friction among the countries, as commerce tilted toward those countries whose currencies were most in line with market forces. For example, when the quetzal parallel exchange rate depreciated substantially from Q.1.45 per dollar to Q.3.80 per dollar, demand for Guatemalan exports increased. The other CACM countries responded by enacting more restrictive barriers to trade, among them stricter import restrictions. This and the scarcity of foreign exchange have hampered producers who require imported inputs to produce goods for exports, thus further aggravating the foreign exchange shortage.

At present the CACM members have just completed the introduction of a new common external tariff agreement. The new tariff reduces the wide range in effective tariff treatment among products, but the average rates are still high. This agreement replaces existing industrial investment regimes in each country as well as enumerates categories of goods which are eligible for inclusion under the new arrangement. Other avenues for increasing exports are also being explored. SIECA, the economic secretariat of the CACM, recently completed a study concerning alternative markets for CACM exports, particularly in Mexico, Columbia, and Venezuela. The study found that CACM members produce many goods which are imported by these countries, such as meat, vegetables, fresh fruit, and cereals. For most of the above products, the United States is currently the primary supplier.

Prospects for the Future

The prospects for increased intraregional trade are not good unless the rifts in the CACM are repaired. Current trade is impeded by the misaligned exchange rates, the growing presence of restrictive measures among the member countries and the inability to settle intraregional trade debts. There has recently been a shift away from the importation of products originating in other CACM countries, mainly due to the difficulties involved with financing such imports. To date, there has been an unwillingness on the part of member countries to unite their political policies to form a system which could be used to the long-term benefit of the members.

For Guatemala, the continued distortions impeding exports to its Central American neighbors will limit the growth of intraregional market opportunities in the near future. However, in order to service its debt repayment requirements and to generate at least a minimal level of growth, the country should increase exports in every area that it can. The Guatemalan economy would, no doubt, benefit from a return to higher levels of intraregional trade, especially if its trading partners are able to pay hard currency (or at least settle in barter) for Guatemalan products. Renewed intraregional trade, however, should not be based on expensive import-substitution production dependent on imported inputs as in the past, but should reflect Guatemala's recent departure from reliance on an overvalued exchange rate.

ANNEX IV
UPDATE OF GUATEMALA MACROECONOMIC DATA
(March 1986)

Introduction:

The economic data contained in the PAAD were prepared during the final quarter of 1985, based on a series of Central Bank projections for 1985 and 1986 which had been compiled at the beginning of the quarter. At the time the Central Bank projections were made, the exchange rate in the parallel market stood at nearly 4 quetzals per dollar, and inflation was raging at record levels. The late 1985 projections assumed that inflation would continue to increase and that the quetzal would depreciate further. The 1986 projections assumed further continuation of these trends.

As described elsewhere in this document, in early October of 1985, the Minister of Finance and the entire top echelon of the Central Bank resigned and were replaced. During the subsequent caretaker administrations of the Ministry of Finance and the Central Bank, no new projections were released. However, some policy actions were taken which substantially influenced the macroeconomic indicators. An exchange rate policy modification for Guatemala's major export crops motivated massive advance sale and repartriation of advance payments for 1986 crops in 1985. The Central Bank also allowed payment of debt obligations to slip. The result was a rapid appreciation of the quetzal in the parallel market, to a peak of 2 quetzales per dollar in a matter of weeks in November. These policies even resulted in real growth of 1985 GDP which was slightly higher than anticipated, at -1.1 percent instead of -1.3 to -1.5.

At the same time, a new price control policy rolled back prices on the commodities of the basic consumer basket to their July levels. These products make up a substantial portion of the consumer price index of goods. Hence, the policy had an impact on measured inflation rates, causing monthly increases in the last months of the year to fall dramatically from the levels which prevailed in August and September.

The factors discussed above combined with the change in government left a great deal of uncertainty about the reliability of the economic data available at the end of 1985, at the time the PAAD was prepared. Beginning in early 1986, there were also dramatic shifts in the prices of several commodities important to Guatemala, particularly coffee and petroleum. This annex serves to update the tables in the PAAD now that better data are available. It also allows the incorporation of the relatively recent commodity price trends into projections for 1986. It is important to note that, while some of the figures have been adjusted over data reported a few months ago, the conclusions of the PAAD about the economic stabilization measures needed, and about 1986 external financing requirements remain the same.

Balance of Payments

Annex 4 Table 1 is an updated version of Table 3, which appears on page 27 of the PAAD text. The following changes have been incorporated into the new table:

-- the impact of the higher coffee price,

-- downward commodity price trends for Guatemalan cotton, petroleum and cardamom,

-- the recent cut in the U.S. sugar quota,

-- the recent increase in the world price for nonquota sugar,

-- a slightly less optimistic outlook for Guatemalan exports to the other CACM countries,

-- reduced imports (over the previous 1986 estimate) due to the newly higher Guatemalan import duties and the reduction in the cost of Guatemala's oil imports.

The balance of payments gap which results from the updated 1986 estimates is $410.5 million. This amount does not take into consideration compensatory financing and debt service relief Guatemala expects to receive upon implementation of a credible stabilization plan, expected in April of 1986.

Fiscal Deficit

The fiscal projections shown in Table 2 of Annex 4 are updates of Table 5 in Annex I of the original PAAD. These estimates incorporate the outcomes of revenue measures taken in early 1986, including the adoption of "Rule 3" which changed import valuation from the official to the parallel exchange rate upon initiation of the new Central American Common External tariff.

5C(1) - COUNTRY CHECKLIST

Listed below are statutory criteria applicable generally to FAA funds, and criteria applicable to individual fund sources: Development Assistance and Economic Support Fund.

A. GENERAL CRITERIA FOR COUNTRY ELIGIBILITY

1. FAA Sec. 481(h)(1); FY 1986 Continuing Resolution Sec. 527. Has it been determined or certified to the Congress by the President that the government of the recipient country has failed to take adequate measures or steps to prevent narcotic and psychotropic drugs or other controlled substances (as listed in the schedules in section 202 of the Comprehensive Drug Abuse and Prevention Control Act of 1971) which are cultivated, produced or processed illicitly, in whole or in part, in such country or transported through such country, from being sold illegally within the jurisdiction of such country to United States Government personnel or their dependents or from entering the United States unlawfully?

The President has not so determined. Guatamala does take adequate steps to prevent narcotics traffic.

2. FAA Sec. 481(h)(4). Has the President determined that the recipient country has not taken adequate steps to prevent (a) the processing, in whole or in part, in such country of narcotic and psychotropic drugs or other controlled substances, (b) the transportation through such country of narcotic and psychotropic drugs or other controlled substances, and (c) the use of such country as a refuge for illegal drug traffickers?

The President has not so determined.

3. FAA Sec. 620(c). If assistance is to a government, is the government liable as debtor or unconditional guarantor on any debt to a U.S. citizen for goods or services furnished or ordered where (a) such citizen has exhausted available legal remedies and (b) the debt is not denied or contested by such government? — No

4. FAA Sec. 620(e)(1). If assistance is to a government, has it (including government agencies or subdivisions) taken any action which has the effect of nationalizing, expropriating, or otherwise seizing ownership or control of property of U.S. citizens or entities beneficially owned by them without taking steps to discharge its obligations toward such citizens or entities? — No

5. FAA Sec. 620(a), 620(f), 620D; FY 1986 Continuing Resolution Sec. 512. Is recipient country a Communist country? If so, has the President determined that assistance to the country is important to the national interests of the United States? Will assistance be provided to Angola, Cambodia, Cuba, Iraq, Syria, Vietnam, Libya, or South Yemen? Will assistance be provided to Afghanistan without a certification? — No

6. FAA Sec. 620(j). Has the country permitted, or failed to take adequate measures to prevent, the damage or destruction by mob action of U.S. property? — No

7. FAA Sec. 620(l). Has the country failed to enter into an agreement with OPIC?

No

8. FAA Sec. 620(o); Fishermen's Protective Act of 1967, as amended, Sec. 5. (a) Has the country seized, or imposed any penalty or sanction against, any U.S. fishing activities in international waters?

(b) If so, has any deduction required by the Fishermen's Protective Act been made?

N/A

9. FAA Sec. 620(q); FY 1986 Continuing Resolution Sec. 518. (a) Has the government of the recipient country been in default for more than six months on interest or principal of any AID loan to the country? (b) Has the country been in default for more than one year on interest or principal on any U.S. loan under a program for which the appropriation bill (or continuing resolution) appropriates funds?

N/A

10. FAA SEC. 620(s). If contemplated assistance is development loan or from Economic Support Fund, has the Administrator taken into account the amount of foreign exchange or other resources which the country has spent on military equipment? (Reference may be made to the annual "Taking Into Consideration" memo: "Yes, taken into account by the Administrator at time of approval of Agency OYB." This approval by the Administrator of the Operational Year Budget can be the basis for an affirmative answer during the fiscal year unless significant changes in circumstances occur.)

Yes, taken into account by the Administrator at time of approval of Agency OYB.

11. FAA Sec. 620(t). Has the country severed diplomatic relations with the United States? If so, have they been resumed and have new bilateral assistance agreements been negotiated and entered into since such resumption?

No

12. FAA Sec. 620(u). What is the payment status of the country's U.N. obligations? If the country is in arrears were such arrearages taken into account by the AID Administrator in determining the current AID Operational Year Budget? (Reference may be made to the Taking into Consideration memo.)

Country is not delinquent.

13. FAA Sec. 620A. Has the government of the recipient country aided or abetted, by granting sanctuary from prosecution to, any individual or group which has committed an act of international terrorism?

No

14. ISDCA of 1985 Sec. 552(b). Has the Secretary of State determined that the country is a high terrorist threat country after the Secretary of Transportation has determined, pursuant to section 1115(e)(2) of the Federal Aviation Act of 1958, that an airport in the country does not maintain and administer effective security measures?

No

15. FAA Sec. 666. Does the country object, on the basis of race, religion, national origin or sex, to the presence of any officer or employee of the U.S. who is present in such country to carry out economic development programs under the FAA? No

16. FAA Sec. 669, 670. Has the country, after August 3, 1977, delivered or received nuclear enrichment or reprocessing equipment, materials, or technology, without specified arrangements or safeguards? Has it transferred a nuclear explosive device to a non-nuclear weapon state, or if such a state, either received or detonated a nuclear explosive device? (FAA Sec. 620E permits a special waiver of Sec. 669 for Pakistan.) No

17. FAA Sec. 670. If the country is a non-nuclear weapon state, has it, on or after August 8, 1985, exported illegally (or attempted to export illegally) from the United States any material, equipment, or technology which would contribute significantly to the ability of such country to manufacture a nuclear explosive device? No

18. ISDCA of 1981-Sec. 720. Was the country represented at the Meeting of Ministers of Foreign Affairs and Heads of Delegations of the Non-Aligned Countries to the 36th General Assembly of the U.N. of Sept. 25 and 28, 1981, and failed to disassociate itself from the communique issued? If so, has the President taken it into account? (Reference may be made to the Taking into Consideration memo.)

Guatemala was not represented at the meeting.

19. FY 1986 Continuing Resolution Sec. 541.

Are any of the funds to be used for the performance of abortions as a method of family planning or to motivate or coerce any person to practice abortions?

No

Are any of the funds to be used to pay for the performance of involuntary sterilization as a method of family planning or to coerce or provide any financial incentive to any person to undergo sterilizations?

No

Are any of the funds to be used to pay for any biomedical research which relates, in whole or in part, to methods of, or the performance of, abortions or involuntary sterilization as a means of family planning?

No

(1)

20. FY 1986 Continuing Resolution. Is the assistance being made available to any organization or program which has been determined as supporting or participating in the management of a program of coercive abortion on involuntary sterilization?

No

If assistance is from the population functional account, are any of the funds to be made available to family planning projects which do not offer, either directly or through referral to or information about access to, a broad range of family planning methods and services?

No

21. FY 1986 Continuing Resolution Sec. 529. Has the recipient country been determined by the President to have engaged in a consistent pattern of opposition to the foreign policy of the United States?

No

22. FY 1986 Continuing Resolution Sec. 513. Has the duly elected Head of Government of the country been deposed by military coup or decree?

B. FUNDING SOURCE CRITERIA FOR COUNTRY ELIGIBILITY

1. Development Assistance Country Criteria

FAA Sec. 116. Has the Department of State determined that this government has engaged in a consistent pattern of gross violations of internationally recognized human rights? If so, can it be demonstrated that contemplated assistance will directly benefit the needy?

No determination has been made regarding gross violations of human rights.

2. Economic Support Fund Country Criteria

FAA Sec. 502B. Has it been determined that the country has engaged in a consistent pattern of gross violations of internationally recognized human rights? If so, has the country made such significant improvements in its human righits record that furnishing such assistance is in the national interest?

No determination has been made of gross violations of human rights.

a\b

5C(3) - STANDARD ITEM CHECKLIST

Listed below are the statutory items which normally will be covered routinely in those provisions of an assistance agreement dealing with its implementation, or covered in the agreement by imposing limits on certain uses of funds.

These items are arranged under the general headings of (A) Procurement, (B) Construction, and (C) Other Restrictions.

A. Procurement

1. FAA Sec. 602. Are there arrangements to permit U.S. small business to participate equitably in the furnishing of commodities and services financed?

2. FAA Sec. 604(a). Will all procurement be from the U.S. except as otherwise determined by the President or under delegation from him??

3. FAA Sec. 604(d). If the cooperating country discriminates against marine insurance companies authorized to do business in the U.S., will commodities be insured in the United States against marine risk with such a company?

4. FAA Sec. 604(e); ISDCA of 1980 Sec. 705(a). If offshore procurement of agricultural commodity or product is to be financed, is there provision against such procurement when the domestic price of such commodity is less than parity? (Exception where commodity financed could not reasonably be procured in U.S.)

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5. FAA Sec. 604(g). Will construction or engineering services be procured from firms of countries which receive direct economic assistance under the FAA and which are otherwise eligible under Code 941, but which have attained a competitive capability in international markets in one of these areas? Do these countries permit United States firms to compete for construction or engineering services financed from assistance programs of these countries?

6. FAA Sec. 603. Is the shipping excluded from compliance with requirement in section 901(b) of the Merchant Marine Act of 1936, as amended, that at least 50 per centum of the gross tonnage of commodities (computed separately for dry bulk carriers, dry cargo liners, and tankers) financed shall be transported on privately owned U.S. flag commercial vessels to the extent such vessels are available at fair and reasonable rates?

7. FAA Sec. 621. If technical assistance is financed, will such assistance be furnished by private enterprise on a contract basis to the fullest extent practicable? If the facilities of other Federal agencies will be utilized, are they particularly suitable, not competitive with private enterprise, and made available without undue interference with domestic programs?

8. International Air Transportation Fair Competitive Practices Act, 1974. If air transportation of persons or property is financed on grant basis, will U.S. carriers be used to the extent such service is available?

9. FY 1986 Continuing Resolution Sec. 504. If the U.S. Government is a party to a contract for procurement, does the contract contain a provision authorizing termination of such contract for the convenience of the United States?

B. Construction

1. FAA Sec. 601(d). If capital (e.g., construction) project, will U.S. engineering and professional services be used?

2. FAA Sec. 611(c). If contracts for construction are to be financed, will they be let on a competitive basis to maximum extent practicable?

3. FAA Sec. 620(k). If for construction of productive enterprise, will aggregate value of assistance to be furnished by the U.S. not exceed $100 million (except for productive enterprises in Egypt that were described in the CP)?

C. <u>Other Restrictions</u>

1. <u>FAA Sec. 122(b)</u>. If development loan, is interest rate at least per annum during grace period and at least 3% per annum thereafter?

2. <u>FAA Sec. 301(d)</u>. If fund is established solely by U.S. contributions and administered by an international organization, does Comptroller General have audit rights?

3. <u>FAA Sec. 620(h)</u>. Do arrangements exist to insure that United States foreign aid is not used in a manner which, contrary to the best interests of the United States, promotes or assists the foreign aid projects or activities of the Communist-bloc countries?

4. Will arrangements preclude use of financing:

   a. <u>FAA Sec. 104(f); FY 1986 Continuing Resolution Sec. 526</u>. (1) To pay for performance of abortions as a method of family planning or to motivate or coerce persons to practice abortions; (2) to pay for performance of involuntary sterilization as method of family planning, or to coerce or provide financial incentive to any person to undergo sterilization; (3) to pay for any biomedical research which relates, in whole or part, to methods or the performance of abortions or involuntary sterilizations as a means of family planning; (4) to lobby for abortion?

b. FAA Sec. 488. To reimburse persons, in the form of cash payments, whose illicit drug crops are eradicated?

c. FAA Sec. 620(g). To compensate owners for expropriated nationalized property?

d. FAA Sec. 660. To provide training or advice or provide any financial support for police, prisons, or other law enforcement forces, except for narcotics programs?

e. FAA Sec. 662. For CIA activities?

f. FAA Sec. 636(i). For purchase, sale, long-term lease, exchange or guaranty of the sale of motor vehicles manufactured outside U.S., unless a waiver is obtained?

g. FY 1986 Continuing Resolution, Sec. 503. To pay pensions, annuities, retirement pay, or adjusted service compensation for military personnel?

h. FY 1986 Continuing Resolution, Sec. 505. To pay U.N. assessments, arrearages or dues?

i. FY 1986 Continuing Resolution, Sec. 506. To carry out provisions of FAA section 209(d) (Transfer of FAA funds to multilateral organizations for lending)?

j. FY 1986 Continuing Resolution, Sec. 510. To finance the export of nuclear equipment, fuel, or technology?

k. FY 1986 Continuing Resolution, Sec. 511. For the purpose of aiding the efforts of the government of such country to repress the legitimate rights of the population of such country contrary to the Universal Declaration of Human Rights?

l. FY 1986 Continuing Resolution, Sec. 516. To be used for publicity or propaganda purposes within U.S. not authorized by Congress?

(())

5C(3) - STANDARD ITEM CHECKLIST

Listed below are the statutory items which normally will be covered routinely in those provisions of an assistance agreement dealing with its implementation, or covered in the agreement by imposing limits on certain uses of funds.

These items are arranged under the general headings of (A) Procurement, (B) Construction, and (C) Other Restrictions.

A. Procurement

1. FAA Sec. 602. Are there arrangements to permit U.S. small business to participate equitably in the furnishing of commodities and services financed?

   Program provides for economic stabilization through a cash transfer.

2. FAA Sec. 604(a). Will all procurement be from the U.S. except as otherwise determined by the President or under delegation from him??

3. FAA Sec. 604(d). If the cooperating country discriminates against marine insurance companies authorized to do business in the U.S., will commodities be insured in the United States against marine risk with such a company?

4. FAA Sec. 604(e); ISDCA of 1980 Sec. 705(a). If offshore procurement of agricultural commodity or product is to be financed, is there provision against such procurement when the domestic price of such commodity is less than parity? (Exception where commodity financed could not reasonably be procured in U.S.)

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FAA Sec. 604(g). Will construction or engineering services be procured from firms of countries which receive direct economic assistance under the FAA and which are otherwise eligible under Code 941, but which have attained a competitive capability in international markets in one of these areas? Do these countries permit United States firms to compete for construction or engineering services financed from assistance programs of these countries?

6. FAA Sec. 603. Is the shipping excluded from compliance with requirement in section 901(b) of the Merchant Marine Act of 1936, as amended, that at least 50 per centum of the gross tonnage of commodities (computed separately for dry bulk carriers, dry cargo liners, and tankers) financed shall be transported on privately owned U.S. flag commercial vessels to the extent such vessels are available at fair and reasonable rates?

7. FAA Sec. 621. If technical assistance is financed, will such assistance be furnished by private enterprise on a contract basis to the fullest extent practicable? If the facilities of other Federal agencies will be utilized, are they particularly suitable, not competitive with private enterprise, and made available without undue interference with domestic programs?

8. International Air Transportation Fair Competitive Practices Act, 1974. If air transportation of persons or property is financed on grant basis, will U.S. carriers be used to the extent such service is available?

9. FY 1985 Continuing Resolution Sec. 504. If the U.S. Government is a party to a contract for procurement, does the contract contain a provision authorizing termination of such contract for the convenience of the United States?

Construction

1. FAA Sec. 601(d). If capital (e.g., construction) project, will U.S. engineering and professional services be used?

2. FAA Sec. 611(c). If contracts for construction are to be financed, will they be let on a competitive basis to maximum extent practicable?

3. FAA Sec. 620(k). If for construction of productive enterprise, will aggregate value of assistance to be furnished by the U.S. not exceed $100 million (except for productive enterprises in Egypt that were described in the CP)?

Other Restrictions

1. FAA Sec. 122(b). If development loan, is interest rate at least 2% per annum during grace period and at least 3% per annum thereafter?

   Yes.

2. FAA Sec. 301(d). If fund is established solely by U.S. contributions and administered by an international organization, does Comptroller General have audit rights?

   Not applicable.

3. FAA Sec. 620(h). Do arrangements exist to insure that United States foreign aid is not used in a manner which, contrary to the best interests of the United States, promotes or assists the foreign aid projects or activities of the Communist-bloc countries?

   Yes.

4. Will arrangements preclude use of financing:

   a. FAA Sec. 104(f); FY 1985 Continuing Resolution Sec. 527. (1) To pay for performance of abortions as a method of family planning or to motivate or coerce persons to practice abortions; (2) to pay for performance of involuntary sterilization as method of family planning, or to coerce or provide financial incentive to any person to undergo

      Yes.

	sterilization; (3) to pay for any biomedical research which relates, in whole or part, to methods or the performance of abortions or involuntary sterilizations as a means of family planning; (4) to lobby for abortion?	Yes. Yes. Yes.
b.	<u>FAA Sec. 488</u>. To reimburse persons, in the form of cash payments, whose illicit drug crops are eradicated?	Yes.
c.	<u>FAA Sec. 620(g)</u>. To compensate owners for expropriated nationalized property?	Yes.
d.	<u>FAA Sec. 660</u>. To provide training or advice or provide any financial support for police, prisons, or other law enforcement forces, except for narcotics programs?	Yes.
e.	<u>FAA Sec. 662</u>. For CIA activities?	Yes.
f.	<u>FAA Sec. 636(i)</u>. For purchase, sale, long-term lease, exchange or guaranty of the sale of motor vehicles manufactured outside U.S., unless a waiver is obtained?	Not applicable.

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g. FY 1985 Continuing Resolution, Sec. 503. To pay pensions, annuities, retirement pay, or adjusted service compensation for military personnel?

Yes.

h. FY 1985 Continuing Resolution, Sec. 505. To pay U.N. assessments, arrearages or dues?

Yes.

i. FY 1985 Continuing Resolution, Sec. 506. To carry out provisions of FAA section 209(d) (Transfer of FAA funds to multilateral organizations for lending)?

Yes.

j. FY 1985 Continuing Resolution, Sec. 510. To finance the export of nuclear equipment, fuel, or technology or to train foreign nationals in nuclear fields?

Yes.

k. FY 1985 Continuing Resolution, Sec. 511. Will assistance be provided for the purpose of aiding the efforts of the government of such country to repress the legitimate rights of the population of such country contrary to the Universal Declaration of Human Rights?

No.

l. FY 1985 Continuing Resolution, Sec. 516. To be used for publicity or propaganda purposes within U.S. not authorized by Congress?

Yes.

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3(A)2 NONPROJECT ASSISTANCE CHECKLIST

The criteria listed in Part A are applicable generally to FAA funds, and should be used irrespective of the program's funding source. In Part B a distinction is made between the criteria applicable to Economic Support Fund assistance and the criteria applicable to Development Assistance. Selection of the criteria will depend on the funding source for the program.

CROSS REFERENCES: IS COUNTRY CHECKLIST UP TO DATE? IDENTIFY. — Yes.

HAS STANDARD ITEM CHECKLIST BEEN REVIEWED? — Yes.

A. <u>GENERAL CRITERIA FOR NONPROJECT ASSISTANCE</u>

1. <u>FY 1986 Continuing Resolution Sec. 524; FAA Sec. 634A.</u>

   Describe how authorizing and appropriations committees of Senate and House have been or will be notified concerning the project.

   This program was presented in the Mission's FY 1986 Congressional Presentation under the title of Economic Stabilization as part of its Economic Support Fund OYB.

2. <u>FAA Sec. 611(a)(2).</u> If further legislative action is required within recipient country, what is basis for reasonable expectation that such action will be completed in time to permit orderly accomplishment of purpose of the assistance?

   The Loan Agreement must be ratified by Guatemala's Congress. Since the President's party has an absolute majority in the Congress, ratification is not expected to be difficult or time consuming.

3. <u>FAA Sec. 209</u> Is assistance more efficiently and effectively given through regional or multilateral organizations? If

   No.

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so, why is assistance not so given? Information and conclusion whether assistance will encourage regional development programs.

4. FAA Sec. 601(a) Information and conclusions whether assistance will encourage efforts of the country to: (a) increase the flow of international trade: (b) foster private initiative and competition; (c) encourage development and use of cooperatives, credit unions, and savings and loan associations; (d) discourage monopolistic practices; (e) improve technical efficiency of industry, agriculture, and commerce; and (f) strengthen free labor unions.

This program provides balance of payments assistance to initiate a stabilization program to assist the economy during the immediate crisis. Other resources will be made available to support additional steps and progression from fundamental measures to greater emphasis on a long-term policy climate to foster productivity and growth. All sectors of Guatemalan society will share the burden of the economic stabilization program. ESF local currency resources will be targetted toward reenergizing private sector growth opportunities and toward projects that sustain the development program objective of increased incomes and opportunities for the rural and urban poor.

5. FAA Sec. 601(b) Information and conclusions on how assistance will encourage U.S. private trade and investment abroad and encourage private U.S. participation in foreign assistance programs (including use of private trade channels and the services of U.S. private enterprise).

The U.S. private sector has a strong role in the Guatemalan industrial and agricultural sectors. This program seeks to initially stabilize the economy which will stimulate their participation and continued investment through a comprehensive policy package including measures tending toward unification of the multiple exchange rate, reduction in the fiscal deficit, increased reliance on domestic savings through liberalization of interest rate policy, and dismantling of the pricing distortions.

6. FAA Sec. 612(b), 636(h); FY 1986 Continuing Resolution Sec. 507. Describe steps taken to assure that, to the maximum extent possible, the country is contributing local currencies to meet the cost of contractual and other services, and foreign currencies owned by the U.S. are utilized in lieu of dollars.

The Government of Guatemala has consistently supported all A.I.D.-financed developmental projects with counterpart necessary to achieve project objectives, and will continue to do so for the present program.

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7. FAA Sec. 612(d). Does the U.S. own excess foreign currency of the country and, if so, what arrangements have been made for its release?	No.
8. FAA Sec. 601(e). Will the assistance utilize competitive selection procedures for the awarding of contracts, except where applicable procurement rules allow otherwise?	Not applicable.
9. FAA 121(d). If assistance is being furnished under the Sahel Development Program, has a determination been made that the host government has an adequate system for accounting for and controlling receipt and expenditure of A.I.D. funds?	N.A.
10. FY 1986 Continuing Resolution Sec. 533. Is disbursement of the assistance conditioned solely on the basis of the policies of any multilateral institution?	No.

B. FUNDING CRITERIA FOR NONPROJECT ASSISTANCE

1. Nonproject Criteria for Economic Support Fund

a. FAA Sec. 531(a). Will this assistance promote economic and political stability? To the maximum extent feasible, is this assistance consistent with the policy directions, purposes, and programs of part I of the FAA?	**The assistance will contribute to the development of a credible and comprehensive stabilization program on the part of the newly elected civilian Government of Guatemala. It is consistent with the policy directions, purposes, and programs of Part I of the FAA.**
b. FAA Sec. 531(c). Will assistance under this chapter be used for military, or paramilitary activities?	No.

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c. FAA Sec. 531(d). Will ESF funds made available for commodity import programs or other program assistance be used to generate local currencies? If so, will such local currencies be available to support activities consistent with the objectives of FAA sections 103 through 106?

Yes.

Yes.

d. ISDCA of 1985 Sec. 205. Will ESF funds made available for commodity import programs be used for the purchase of agricultural commodities of United States-origin? If so, what percentage of the funds will be so used?

Not applicable.

e. ISDCA of 1985 Sec. 801. If ESF funds will be used to finance imports by an African country (under a commodity import program or sector program), will the agreement require that those imports be used to meet long-term development needs in those countries in accordance with the following criteria?

Not applicable.

(i) spare parts and other imports shall be allocated on the basis of evaluations, by A.I.D., of the ability of likely recipients to use such spare parts and imports in a maximally productive, employment generating, and cost effective way;

(ii) imports shall be coordinated with investments in accordance with the recipient country's plans for promoting economic development. A.I.D. shall assess such plans to determine whether they will effectively promote economic development;

(iii) emphasis shall be placed on imports for agricultural activities which will expand agricultural production, particularly activities which expand production for export or production to reduce reliance on imported agricultural products;

(iv) emphasis shall also be placed on a distribution of imports having a broad development impact in terms of economic sectors and geographic regions;

(v) in order to maximize the likelihood that the imports financed by the United States under the ESF chapter are in addition to imports which would otherwise occur, consideration shall be given to historical patterns of foreign exchange uses;

(vi)(A) seventy-five percent of the foreign currencies generated by the sale of such imports by the government of the country shall be deposited in a special account established by that government and, except as provided in subparagraph (B), shall be available only for use in accordance with the agreement for economic development activities which are consistent with the policy directions of section 102 of the FAA and which are the types of activities for which assistance may be provided under sections 103 through 106 of the FAA;

(B) the agreement shall require that the government of the country make available to the United States Government such portion of the amount deposited in the special account as may be determined by the President to be necessary for requirements of the United States Government.

f. <u>ISDCA of 1985 Sec. 207.</u> Will ESF funds be used to finance the construction of, or the operation or maintenance of, or the supplying of fuel for, a nuclear facility? If so, has the President certified that such country is a party to the Treaty on the Non-Proliferation of Nuclear Weapons or the Treaty for the Prohibition of Nuclear Weapons in Latin American (the "Treaty of Tlatelolco"), cooperates fully with the IAEA, and pursues nonproliferation policies consistent with those of the United States?

No.

g. <u>FAA Sec. 609.</u> If commodities are to be granted so that sale proceeds will accrue to the recipient country, have Special Account (counterpart) arrangements been made?

Not applicable.

2. Nonproject Criteria for Development Assistance

a. FAA Sec. 102(a); 111; 113; 281(a). Extent to which activity will (a) effectively involve the poor in development, by extending access to economy at local level; increasing labor-intensive production and the use of appropriate technology, spreading investment out from cities to small towns and rural areas, and insuring wide participation of the poor in the benefits of development on a sustained basis, using the appropriate U.S. institutions; (b) help develop cooperatives, especially by technical assistance, to assist rural and urban poor to help themselves toward better life, and otherwise encourage democratic private and local governmental institutions; (c) support the self-help efforts of developing countries; (d) promote the participation of women in the national economies of developing countries and the improvement of women's status; and (e) utilize and encourage regional cooperation by developing countries?

Not applicable.

b. FAA Sec. 103, 103A, 104, 105, 106, 107. Is assistance being made available: (include only applicable paragraph which corresponds to source of funds used. If more than one fund source is used for assistance, include relevant paragraph for each fund source.)

(1) [103] for agriculture, rural development or nutrition; if so (a) extent to which activity is specifically designed to increase productivity and income of rural poor; [103A] if for agricultural research, full account shall be taken of the needs of small farmers, and extensive use of field testing to adapt basic research to local conditions shall be made; (b) extent to which assistance is used in coordination with efforts carried out under Sec. 104 to help improve nutrition of the people of developing countries through encouragement of increased production of crops with greater nutritional value, improvement of planning, research, and education with respect to nutrition, particularly with reference to improvement and expanded use of indigenously produced foodstuffs; and the undertaking of pilot or demonstration of poor and vulnerable people; and (c) extent to which activity increases national food security by improving food policies and management and by strengthening national food reserves, with particular concern for the needs of the poor, through measures encouraging domestic production, building national food reserves, expanding available storage facilities, reducing post harvest food losses, and improving food distribution.

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(2) [104] for population planning under sec. 104(b) or health under sec. 104(c); if so, extent to which activity emphasizes low-cost, integrated delivery systems for health, nutrition and family planning for the poorest people, with particular attention to the needs of mothers and young children, using paramedical and auxiliary medical personnel, clinics and health posts, commercial distribution systems and other modes of community research.

(3) [105] for education, public administration, or human resources development; if so, (a) extent to which activity strengthens nonformal education, makes formal education more relevant, especially for rural families and urban poor, or strengthens management capability of institutions enabling the poor to participate in development; and (b) extent to which assistance provides advanced education and training of people in developing countries in such disciplines as are required for planning and implementation of public and private development activities.

(4) [106] for technical assistance, energy, research, reconstruction, and selected development problems; if so, extent activity is: (i)(a) concerned with data

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collection and analysis, the training of skilled personnel, research on and development of suitable energy sources, and pilot projects to test new methods of energy production; and (b) facilitative of geological and geophysical survey work to locate potential oil, natural gas, and coal reserves and to encourage exploration for potential oil, natural gas, and coal reserves.

(ii) technical cooperation and development activities, especially with U.S. private and voluntary, or regional and international development, organizations;

(iii) research into, and evaluation of, economic development processes and techniques;

(iv) reconstruction after natural or manmade disaster;

(v) for special development problems, and to enable proper utilization of earlier U.S. infrastructure, etc., assistance;

(vi) for special development, especially small labor-intensive enterprises, marketing systems, and financial or other

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institutions to help urban poor participate in economic and social development.

(5) [107] is appropriate effort placed on use of appropriate technology? (Relatively smaller, cost-saving, labor using technologies that are generally most appropriate for the small farms, small businesses, and small incomes of the poor.)

c. FAA 118(c) and (d). Does the assistance comply with the environmental procedures set forth in AID Regulation 16. Does the assistance take into consideration the problem of the destruction of tropical forests?

d. FAA Sec. 281(b) Describe extent to which the activity recognizes the particular needs, desires, and capacities of the people of the country; utilizes the country's intellectual resources to encourage institutional development; and supports civic education and training in skills required for effective participation in governmental and political processes essential to self-government.

e. FAA Sec. 122(b) Does the activity give reasonable promise of contributing to the development of economic resources, or to the increase of productive capacities and self-sustaining economic growth?

AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON, D.C. 20523

LAC/DR-IEE-86-10

ENVIRONMENTAL THRESHOLD DECISION

Project Location	:	Guatemala
Project Title and Number	:	Balance of Payments 520-0347
Funding	:	47,350,000 (ESF)
Life of Project	:	1 year
IEE Prepared by	:	USAID/Guatemala
Recommended Threshold Decision	:	Categorical Exclusion
Bureau Threshold Decision	:	Concur with Recommendation
Comments	:	Concurrence subject to condition being placed in approval documents not to procure pesticides without first doing an Environmental Assessment on them and having it approved by AID/W.
Copy to	:	Charles Costello, Director USAID/Guatemala
Copy to	:	LAC/DR/CEN, Lars Klassen
Copy to	:	ROCAP/San Jose, Frank Zadroga
Copy to	:	IEE File

James S. Hester Date MAY - 2 1986

James S. Hester
Chief Environmental Officer
Bureau for Latin America
and the Caribbean

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UNCLAS GUATEMALA 03232

AIDAC

E. O. 12356: N/A
SUBJECT: AID/GUATEMALA FY86 PAAD: DUPLICATE COPY OF CABLE SENT 3/13/86

REF: A) LODLE/RYOUSSEF/MOTT TELCON 2/20/86, B) LODLE/JHESTER TELCON 2/20/86

1. IN REF TEL A AID/W REQUESTED MISSION SUBMISSION OF A RECOMMENDATION FOR AN ENVIRONMENTAL DETERMINATION FOR THE PAAD. UNDER ANNEX 2D CHAPTER 3, HANDBOOK 3 SECTION 216.2. APPLICABILITY OF PROCEDURES SUBSECTIONS (C) CATEGORICAL EXCLUSIONS, ITEM (2) (VI) STATES THAT QUOTE CONTRIBUTIONS TO ... NATIONAL ORGANIZATIONS BY THE UNITED STATES WHICH ARE NOT FOR THE PURPOSE OF CARRYING OUT A SPECIFICALLY IDENTIFIABLE PROJECT OR PROJECTS UNQUOTE ARE NOT SUBJECT TO AID'S ENVIRONMENTAL PROCEDURES. THE AID/GUATEMALA FY86 PAAD PROVIDES FOR THE CASH TRANSFER TO THE GUATEMALAN NATIONAL BANK FOR BALANCE OF PAYMENTS SUPPORT. AS SUCH THE PAAD DOES NOT PROVIDE AID FUNDS FOR IDENTIFIABLE PROJECTS, RATHER IT PROVIDES FUNDS FOR AN ECONOMIC STABILIZATION PROGRAM.

2. BASED ON THE DISCUSSION PROVIDED IN PARAGRAPH 1 ABOVE THE MISSION RECOMMENDS THAT NO FURTHER ENVIRONMENTAL STUDY BE UNDERTAKEN FOR THIS PAAD AND THAT A NEGATIVE DETERMINATION BE GRANTED. PIEDRA